STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

CONSUMERS ILLINOIS WATER COMPANY	**:**	
	:	
Tariffs seeking general increase in water	**:**	**03-0403**
Rates for the Kankakee Water Division	**:**	
(Tariffs filed on May 21, 2003)	**:**	

ADMINISTRATIVE LAW JUDGE'S PROPOSED ORDER

March 1, 2004

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ADMINISTRATIVE LAW JUDGE'S PROPOSED ORDER

By the Commission:

I. INTRODUCTION

A. Procedural History

On May 21, 2003, Consumers Illinois Water Company, Kankakee Water Division ("CIWC" or "Company") filed revised tariff sheets in which it proposed a general increase in water rates to become effective July 5, 2003. These tariff sheets were identified as Ill.C.C. No. 47, Section 2: Third Revised Sheet Nos. 2, 3, 4 and 5 and Fourth Revised Information Sheet. The Company simultaneously provided written direct testimony supporting the proposed general increase, by Mr. Thomas J. Bunosky, Mr. Jack Schreyer, and Ms. Pauline M. Ahern. On June 18, 2003, the Illinois Commerce Commission ("Commission") suspended the filing to and including October 18, 2003, for a hearing on the proposed rate increase. On October 8, 2003, the Commission re-suspended the tariffs to and including April 18, 2004.

On September 19, 2003, Staff filed the Direct Testimony of Mr. Bryan Sant, Mr. Thomas Q. Smith, Mr. Mike Luth, and Ms. Sheena Kight. The Supplemental Direct Testimony of Mr. Sant and Mr. Smith was filed on October 3, 2003. Rebuttal Testimony of Company witnesses Ahern and Schreyer was filed on October 20, 2003. Staff rebuttal testimony of all of the Staff witnesses was filed on November 17, 2003. Company surrebuttal was filed on December 1, 2003.

No Petitions for Leave to Intervene in this matter were filed. However, requests for a local public forum regarding the proposed increase were made by the Village of Bourbonnais, the Kankakee County Board, the Organization United to Reverse All Governments' Excesses (OUTRAGE), and the Village of Bradley. The forum was held at a public location within the service territory on October 29, 2003.

Pre-hearing conferences were held in this matter on August 7, 2003; October 22, 2003; November 12, 2003; and December 4, 2003. Evidentiary hearings were conducted on December 9 and 16, 2003. At the conclusion of the hearing on December 16, 2003, the record was marked "Heard and Taken."

B. Nature of Operations

CIWC is engaged in the business of providing water service to the public in Illinois. The Company's Kankakee Division serves a population of approximately 78,000 located in the City of Kankakee, Village of Aroma Park, Village of Bradley, Village of Bourbonnais, Village of Grant Park, The Illinois Diversatech Campus located to the east of the Village of Manteno, and parts of the townships of Aroma, Bourbonnais, Kankakee, Manteno, Limestone, Summer, Otto, and Yellowhead.

The rates in existence during the pendency of this proceeding were established by the Order entered January 31, 2001, in Dockets 00-0337/00-0338/00-0339 (consol.). The Company states that the reasons for the instant rate filing are to permit it to recover its operations and maintenance expenses, to provide an opportunity to earn a fair return on its capital, and to reflect significant increases to both rate base and expenses since the entry of the previous rate Order.

C. Test Year

The Company proposed, and Staff accepted, a future test year of the twelve months ending December 31, 2004. The 2004 test year data were based on the Company's 2003 and 2004 projections of revenues, expenses and rate base items. The specific procedures followed and assumptions made in developing the projections were discussed in the Direct Testimony of Mr. Schreyer.

This filing uses the filing and test year rules provided in 83 Ill. Adm. Code Parts 285, 286, and 287, pursuant to the Order entered by the Commission on April 23, 2003, in Docket 03-0187. That Order granted a waiver the requirements of then-existing Part 285 rules, in favor of the requirements of new Parts 285, 286, and 287. At that time, the new Code Parts had been promulgated under a Second Notice of Proposed Rulemaking in Docket 02-0509. Old Part 285 was repealed, and new Parts 285, 286, and 287 were adopted, with an effective date of August 1, 2003.

The Company offered the opinion of the London Witte Group, an independent certified public accounting firm, stating that the Company complied with the Guide for Prospective Financial Information (1999), issued by the American Institute of Certified Public Accountants, in the preparation and presentation of its projections. Other statements and information required by the New Filing Requirements for the use of a future test year also were provided by the Company. No party objected to the Company's use of a 2004 Future Test Year. Based on the evidence, the Commission finds that the 2004 test year should be used in setting rates in this proceeding.

II. RATE BASE

A. Introduction and Company Proposal

The rate base represents the net level of investment that a utility has dedicated to public service on which it is entitled to earn a return. The rate base consists principally of book investment in plant, and working capital, less deductions to reflect other sources of funds, such as deferred taxes.

Schedules showing the Company's rate base at present and recommended rates for the test year ending December 31, 2004, are presented by Company and Staff witnesses. Staff proposes one adjustment to the proposed rate base of CIWC, as discussed below. CIWC's proposed original cost rate base is as follows:

CIWC's Proposed Rate Base
($)

Gross Utility Plant in Service	$70,339,526
(Less) Accumulated Amort. of Util. Plant Acquisition Adjustment	62,880
(Less) Accumulated Depreciation	(17,482,695)
Net Original Cost of Plant	52,919,711
Property Held for Future Use	-
Deferred Charges	290,346
Materials and Supplies	515,719
Cash Working Capital	762,626
Amortization of CIAC	1,922,072
FAS 87 Pension	(246,896)
Customer Advances	(1,803,327)
Contributions in Aid of Construction	(8,930,085)
Deferred Income Taxes – Total	(4,686,705)
Materials and Supplies Payable	-
Acquisition Adjustment	-
Total Rate Base	$40,743,461

B. Uncontested Adjustments

1. Materials and Supplies – Payables

Staff proposes a reduction to the Company's rate base for the amount of materials and supplies accounts payable. The Company does not oppose the theory of this adjustment, but it did note an error, which was corrected by Staff on rebuttal. Staff and CIWC concur in the corrected adjustment.

2. Accumulated Deferred Income Tax, Alternative Minimum Tax

Staff proposes an adjustment to properly reflect average pro-rated deferred income tax. The Company agrees with the adjustment, but notes that there was an error in reducing rate base by the alternative minimum tax. Staff agrees with CIWC that alternative minimum taxes should not be used to reduce rate base.

3. Cash Working Capital

The Company and Staff agree on the calculation of CIWC's cash working capital requirement. The parties further agree that cash working capital should be adjusted to reflect the final expenses ordered by the Commission. Despite agreement on the method of calculation, Staff and the Company disagree on certain adjustments to the expenses, as discussed below.

C. Contested Adjustment: Grant Park Acquisition

1. Staff Proposal

Staff proposes an adjustment so that the acquisition by CIWC in 2003 of the Grant Park water system is reflected properly in the test year average rate base balance. The balances to be adjusted are plant in service, accumulated depreciation, contributions in aid of construction ("CIAC"), accumulated amortization of CIAC, acquisition adjustment, and accumulated amortization of acquisition adjustment. Concurrently, Staff proposes an adjustment to increase depreciation expense to account for the increase in plant in service balance due to the acquisition. According to Staff, the Company accepts much of the adjustment. What remains at issue concerns the additional depreciation reserve and accumulated amortization of CIAC reflecting the difference between the original cost study date and the date of actual acquisition.

Staff asserts that the Order in 02-0480 did not, in fact, lock in the accounting entries listed in Appendix C thereto, despite approving them within the Order that allows the acquisition. Instead, Staff relies on Finding 21, in which CIWC "is directed to file [a] copy of the actual journal entries recording this transaction … within six months of the Order in the proceeding." (Order, 02-0480 (Mar. 18, 2003), at 10.) Staff points out that this text implies that the final transaction need not be the exact dollar amount as the estimate submitted for regulatory approval. Since almost nineteen months passed between the study underlying the entries listed in Appendix C and the date the acquisition became final, Staff posits that it is likely that certain updates will be necessary.

For the nineteen month period, the water system was continuing to service Grant Park. Staff argues that it is therefore appropriate to continue to accumulate depreciation and amortization upon the various plant items. Staff recognizes approval of the Appendix C journal entries, but asserts that its proposed adjustments should be adopted to avoid creating a period during which the target water system was active but normal accounting entries were suspended.

Similarly, Staff asserts that there is no asymmetry in the rates imposed by its proposal. The Company disagrees with its adjustment to accumulated depreciation, Staff concludes, because it does not recover the accompanying depreciation expense during that same time period. Staff points out, however, that CIWC did not own the system during the period in question, and therefore could not recover that expense.

Staff agrees with the Company's premise that depreciation expense is recovered from ratepayers, and therefore accumulated depreciation reduces rate base because it represents non-investor supplied funds. Staff asserts, however, that its proposal does not deny the Company an opportunity to earn a return on all of its investment. Because the Company did not own the assets prior to April, 2003, Staff argues, none of the accumulated depreciation correctly recorded as of the acquisition date represents investor-supplied funds, nor should a return on it be recovered from the ratepayers. Also, in response to the Company's argument that updating the reserve for depreciation may require updates to several other figures, Staff notes that the original cost of plant, CIAC, and cash are historical amounts that do not change. Only the depreciation and amortization figures are subject to change, along with the acquisition adjustment that includes those figures.

2. Company Position

On March 18, 2003, the Commission entered an Order in Docket 02-0480 approving the acquisition and operation of the Village of Grant Park water system by Consumers Illinois Water Company, Kankakee Division. The Company explains that, to account for the acquisition, the Commission approved certain journal entries that reflect the results of an original cost study dated October, 2001. The Commission-approved journal entries are attached to the Order in 02-0480 as Appendix C. The Company notes that it and Staff agree that, effective on the acquisition closing date of April 23, 2003, depreciation expense should be booked on the Grant Park assets, and accumulated depreciation therefore will increase accordingly. According to the Company, the increase in accumulated depreciation between October, 2001 and April 23, 2003, is the sole issue.

The Company avers that Staff's proposal would result in an accounting mismatch that would inhibit it from earning a return on part of its investment. CIWC explains that accumulated depreciation is a deduction to rate base, because it is the accumulation of the depreciation expense which has been recovered from ratepayers. Thus, it is non-investor supplied capital upon which a utility is not entitled to earn a return. Therefore, the Company argues, decreasing rate base by increasing accumulated depreciation would not be accompanied by a recovery of the depreciation expense during the same period of time, i.e. October, 2001, through April, 2003.

The Appendix C entries approved in 02-0480, CIWC asserts, are in essence:

Debit	Plant in Service	$1,788,952	
Credit	Reserve for Depreciation		$469,968
Credit	Contributions in Aid of Construction		$175,044

Credit	Cash		$66,000
Credit	Utility Plant Acquisition Agreement		$1,077,940
		$1,788,952	$1,788,952

The Company perceives Staff to agree that the Utility Plant in Service should be increased by $1,788,952 based on the study dated October, 2001. Yet, according to CIWC, Staff seeks to revise accumulated depreciation through the date of the transaction in April, 2003, with no provision to adjust depreciation expense during the same period. Such an adjustment violates the symmetry inherent in ratemaking. Furthermore, the Company notes that Staff had to estimate depreciation expense from the original cost study date in 2001 through the acquisition closing date, because depreciation expense was not collected by Grant Park from customers in rates. Similarly, no evidence exists of what that expense might have been because the Company did not own the assets.

3. Commission Conclusion

The first issue to be resolved concerns the proper interpretation of the language in the Order entered in 02-0480. The ordering clauses approve the journal entries attached as Appendix C, and direct the Company to "file one copy of the actual journal entries recording this transaction … within 6 months of the Order in this proceeding." (Order, 02-0480, at 11.) The latter clause does not contradict the former. The former clause allows for approval of the accounting treatment of the transaction by reflecting the best estimate of data available during the pendency of that Docket. The latter clause recognizes that the transaction would not actually close on the day the Order was entered and, therefore, the journal entries reflecting the actual data as of the close of the transaction would need to be provided subsequent to the closing.

The Commission concludes that, until the transaction actually closed, the acquired system was operated by its former owner, and it continued to depreciate due to its operation. CIWC could not have recorded any depreciation expense on its books during the period in question since it was not the owner of the property until April, 2003. The Commission believes that it would be anomalous to suspend the accrual of accumulated depreciation during the period from October, 2001, through April, 2003, simply because an accounting treatment had been approved in the acquisition docket. The updated accumulated depreciation balance, including the accrual for the period in question, is necessary to represent the actual net plant acquired by CIWC at the closing of the transaction.

The Commission also finds CIWC's symmetry arguments to be unpersuasive. The revenue requirement adopted in this proceeding will provide the appropriate level of test year depreciation expense. Accordingly, the Commission concludes that the adjustment proposed by Staff is proper and should be implemented.

D. Approved Rate Base

Giving effect to the adjustment to rate base approved above, the Commission concludes that CIWC's original cost rate base for the test year is $40,622,884. This rate base may be summarized as follows:

Approved Rate Base
($)

Gross Utility Plant in Service	$72,128,478
(Less) Accumulated Amort. Of Util. Plant Acquisition Adjustment	62,880
(Less) Accumulated Depreciation	(18,071,628)
Net Original Cost of Plant	54,119,730
Property Held for Future Use	-
Deferred Charges	290,346
Materials and Supplies	411,999
Cash Working Capital	755,880
Amortization of CIAC	1,931,170
FAS 87 Pension	(246,896)
Customer Advances	(1,803,327)
Contributions in Aid of Construction	(9,105,129)
Deferred Income Taxes - Total	(4,678,183)
Materials and Supplies Payable	(34,333)
Acquisition Adjustment	(1,018,373)
Total Rate Base	$40,622,884

III. OPERATING REVENUE, EXPENSES, AND INCOME

A. Introduction and Company Proposal

Schedules showing the operating revenues, expenses and income at present and recommended rates for the test year ending December 31, 2004, are presented by CIWC and Staff witnesses. Staff proposed a number of adjustments to the CIWC proposed operating statement, as discussed below. CIWC's proposed operating income statements is as follows:

CIWC's Proposed Operating Income Statement

Operating Revenue	$ 12,823,160
Miscellaneous Operating Revenues	274,146
QIP Revenue	-
Total Operating Revenue	13,097,306
Uncollectibles Expense	41,652
Salaries & Wages	1,824,207
Pensions & Benefits	667,594
Purchased Power & Fuel	392,449
Chemicals	316,619
Materials & Supplies	187,690
Contractual Services	1,599,132
Lease Expense	18,185
Transportation Expense	155,196
Insurance Expense	231,261
Regulatory Expense Amortization	65,917
Miscellaneous Expense	193,321
Depreciation Expense	1,854,223
Amortization	(50,734)
Taxes other than Income	659,981
Total Operating Expense Before Income Taxes	8,156,693
State Income Tax	243,726
Federal Income Tax	1,102,775
ITCs Net	(21,276)
Total Operating Expenses	9,481,918
Net Operating Income	$3,615,388

B. Uncontested Adjustments

1. Social and Service Company Membership

Staff proposes, and the Company does not contest, an adjustment to disallow social and service club membership dues that are for country club memberships. Staff asserts that, while country club memberships are benefits for management provided by the Company, they are not necessary for providing water service. Accordingly, ratepayers should not be responsible for their cost.

2. Industry Association Dues

Staff proposes two reductions to industry association dues. First, consistent with Section 9-224 of the Act, Staff's adjustment removes the portion of dues related to lobbying efforts. Second, the adjustment removes dues to community and economic development organizations. Staff proposes this reduction because participation in community and economic development groups is a promotional and goodwill practice that is not necessary in providing utility service. Although the Company believes that dues paid to local community organizations does not constitute a burden to the ratepayers, the Company accepted Staff's adjustments to industry association dues.

3. Materials and Supplies

Staff and the Company reached agreement on an adjustment to smooth out certain monthly balances for materials and supplies contained in the initial forecast. Staff and CIWC concur that the adjustment provides a reasonable forecast for the test year balances.

4. Lease Expense

Staff proposes an adjustment to test year lease expense. Some equipment, such as that used for administrative and general functions, have leases that are easily identifiable in scope and amount for the test year. For that equipment, Staff included in its calculation the actual contracted amount attributable to the test year. For other equipment used only occasionally, including certain operating and maintenance items, Staff avers that it is more reasonable to include in the revenue requirement a normalized historical figure rather than the budgeted amount. For this portion of lease expense, Staff calculates the normalized amount based on a three-year average. The Company does not contest Staff's adjustment to lease expense.

5. Inflation

Staff witness Smith proposed an adjustment to escalate test year costs using a 2% general inflation factor rather than the 3% general inflation factor initially proposed by the Company. This adjustment increases expenses that have not been specifically analyzed as to appropriate increases or decreases from past levels. The Company accepted this adjustment.

6. QIPS Revenue

The Company has a Qualified Infrastructure Adjustment and Plant Surcharge rider that provides for the recovery of carrying cost on certain plant additions. This rider will cease to exist once rates are established in this Docket, so these revenues should be removed from test year operating income. The Company does not object to this adjustment.

7. Wastewater Billing Revenue

Staff asserts that, because the Company uses utility resources to provide billing services to other entities, the revenues derived from these services are properly included in utility revenue. The Company does not contest this adjustment.

8. Lab Testing Revenue

Because the Company uses utility resources to provide lab testing services to other entities, Staff explains, the revenues derived from these services are properly included in utility revenue. The Company does not contest this adjustment.

9. Bottled Water Revenue

Staff contends that, because the Company uses utility resources to bottle water, the revenues derived from the sale of this bottled water are properly included in utility revenue. The Company does not contest this adjustment.

C. Contested Adjustments

1. Wages and Salaries Expense

a) Staff Proposal

Staff witness Smith proposes that expenses associated with three unfilled but budgeted employee positions be eliminated. Staff asserts that, under normal conditions, more employee positions are budgeted than actually filled. Accordingly, Staff argues, the Company operates efficiently at less than its budgeted headcount. Staff concludes, therefore, that the expense of budgeted employees not employed represents not only an operating inefficiency but also a ratemaking abnormality. Rates should reflect the cost of efficient operations on a normal ongoing basis, and because these positions are expected to be unfilled on average, Staff avers that the expense of those employees is properly eliminated from revenue requirement. Staff also suggests that it is not appropriate to accept its proposed adjustment trimming the positions, but then award the increase in overtime expense instead.

Mr. Smith notes that the Company has operated with fewer than the budgeted number of employees in recent years, and also states that no claim has been made that those operations were less than efficient. Although the Company argues that the salaries should be included in the revenue requirement if the positions are filled by the end of 2003 as planned, Staff remains troubled that funding the full headcount is inconsistent with the historical experience of the Company. Staff contends that, even if the three positions are filled, three others, on average, will become vacant. According to Staff, the issue does not concern specific positions, but rather the pattern of operations.

Staff acknowledges that Company witness Schreyer identifies overtime expenses in 2001, 2002, and 2003, but asserts that there is no evidence that these overtime expenses resulted from vacant positions. Instead, Staff contends that overtime merely signifies that employees did not complete their work during the normal work day, due to either inadvertent understaffing or unexpected events. Staff underscores that no evidence suggests that the overtime identified by Mr. Schreyer is the result of budgeted positions not being filled, nor that it was not anticipated and budgeted separately. Staff asserts that overtime expenses are routinely incurred at a full complement of employees, because it is sometimes reasonable to have a full time employee work extra hours rather than to hire a temporary employee for a few hours of work. Additionally, it is reasonable to expect that the budget process provides for the inclusion of overtime wages.

According to Staff, the Company wrongly suggests that there is a connection between Mr. Smith’s adjustment and the fact that he did not compare the number of employees per customer at CIWC with other utilities. The number of customers at other utilities, Staff contends, is irrelevant to the cost of providing service to the customers of CIWC.

Staff also agrees that the Wages and Salaries adjustment related to unfilled vacancies is properly calculated without consideration for incentive compensation expense in the amount of $48,720. Staff states that if the vacant position adjustment is accepted, but the incentive compensation adjustment is rejected, then the adjustment as calculated on ICC Staff Exhibit 8.0, Schedule 8.6 page 1 must be modified to remove the $48,720 deduction for the incentive bonuses.

b) Company Position

The Company disagrees with Staff's adjustment to remove the wages for three positions that Staff asserts, on average, are vacant. Instead, CIWC asserts that its full wage expense of $1,824,207 should be granted, or alternatively, that an additional $60,303 be granted to cover the incremental overtime that will be incurred in the absence of the three positions at issue.

Company witness Schreyer explained that if any of the 55.5 authorized positions are vacant, there is a comparable level of overtime expense which needs to be included in cost of service in order to ensure safe and adequate service to its customers. Mr. Schreyer noted that the Transmission and Distribution Department incurred 2,790 hours and $83,380 in overtime in 2001; 3,324 hours or $103,186 in 2002; and 5,291 hours or $163,489 to date in 2003. The Company contends that increase in overtime of $60,303 from the year 2002 through late 2003 reflects the Company's need for the additional three employees denied by Staff. Mr. Schreyer testified that CIWC planned to fill the three positions prior to the end of 2003.

The Company also asserts that Staff did not compare CIWC to other similar utilities in terms of the ratio of employees to customers. Staff has not alleged that the staffing levels are unreasonable, either for the customer base served or relative to other utilities. The Company also argues that, for Staff to eliminate hypothetical employees without analyzing overtime hours is to conduct only part of the analysis of the cost of providing service. By focusing on budgeted but unfilled positions, CIWC maintains, Staff ignores overtime hours and dollars that exceed budget, and the reasons the overtime occurred.

When overtime is required, CIWC argues, it is for the purpose of maintaining safe and adequate service, as required by the Act. The record reflects that an increasing level of overtime was incurred as the budgeted level of 55.5 of employees was unfilled. With three positions unfilled, the Company argues that the incremental increase in overtime of $60,303 should be included in cost of service.

c) Commission Conclusion

The Commission concludes that Staff's adjustment should not be adopted. The Company has presented testimony that it intends to fill the three positions at issue before the start of the test year. It also offered testimony as to its overtime hours and costs, which increased dramatically in the previous years.

Staff objects that there is a historical pattern that three positions are not filled on average. Staff also suggests that it is not three particular positions at issue, but rather an average of three positions within CIWC as a whole. The Commission is troubled, however, that these principles are speculative with respect to the future test year and the situation of CIWC. In light of its pattern of increasing overtime, as well as the planned hiring of three employees, the Commission cannot conclude that any open positions will remain unfilled during the test year. Similarly, the Commission notes that the Company increased its service territory in the middle of 2003 with the acquisition of the Grant Park water system. There is some uncertainty about the extent to which the acquisition places an additional demand on employee hours, but it is highly unlikely to actually decrease the work load.

Staff further argues that there is a lack of evidence that the overtime expenses are related to the vacancies. While unexpected events may make overtime expense unavoidable from time to time, the Commission doubts that unexpected events fully explain the clear rise in overtime required over the previous three years. Therefore, based upon the facts of this case, the Commission concludes that Staff's adjustment should not be adopted.

2. Employee Benefits Expense

a) Staff Proposal

In connection with his adjustment removing three vacant employee positions from CIWC's revenue requirement, Staff witness Smith proposes that the employee benefits expenses for these positions should be removed as well. Staff agrees with the Company that it is proper to use 55.5, rather than 55, employees to calculate this adjustment. Staff also states that there is no dispute as to the merits of this adjustment; both the Company and Staff agree that if the vacant employee adjustment is not accepted by the Commission, then this adjustment is also properly rejected.

While Staff does not necessarily disagree with the Company that increased overtime will result in increased benefits and tax expense, Staff contends that the Company did not prove that future actual overtime expenses under normal conditions will be different from the test year level. Staff also argues that the Company failed to identify the amount of change in employee benefits expense associated with any incremental change in overtime.

b) Company Position

The Company explains that Staff's adjustment decreasing employee benefits expense by $46,353 relates to its proposal decreasing wage expense related to three average vacant positions. The adjustment decreases cost of service for the pension benefits and payroll taxes related to those three positions. The Company asserts that this amount should be fully included in the cost of service, along with its full wages and salaries expense.

The Company acknowledges that this adjustment directly relates to the adjustment to wages and salaries expense. It notes, however, that a decrease in straight time necessarily involves an increase in overtime, which in turn results in an increase in pension benefits and payroll taxes. Therefore, CIWC asserts, both this adjustment and the related adjustment to wages and salaries expense should be rejected, because they fail to incorporate the total cost of labor.

Instead, CIWC recommends that the Commission accept the Company's level of 55.5 employees, as well as its proposed benefits expense of $857,535. If the Commission accepts Staff's adjustment eliminating the three positions, however, CIWC requires a further allocation in the amount of 7.65% of the additional overtime, or $4,613, to recover the payroll taxes owed thereon.

c) Commission Conclusion

The Commission notes that CIWC and Staff agree that the outcome of this issue is dependent on the outcome of the proposed adjustment to wages and salaries expense. Since the Commission declines to adopt the adjustment proposed in the prior issue, it also declines to adopt the instant adjustment. The Company's alternative arguments seeking additional overtime expenses, therefore, are rendered moot.

3. Incentive Compensation Expense

a) Staff Proposal

Staff recommends the elimination of incentive compensation expenses from revenue requirement. Staff views the bonuses to depend upon earnings performance. Ratepayers are disadvantaged, Staff argues, because they are responsible for the cost of incentive compensation whether or not the bonuses are paid. If the Company withholds payment of incentive compensation, Staff contends that the burden of poor earnings is shifted from investors to ratepayers. In this sense, Staff contends that incentive compensation serves more as an insurance policy against managerial inefficiency for the Company than as a legitimate expense to be recovered in rates.

Staff also alleges that recovery of incentive compensation violates fundamental ratemaking principles. The rates that are set presume that costs cannot be reduced further, Staff argues, because any cost reduction would then result in something other than reasonable cost. According to Staff, the recovery of incentive compensation in conjunction with set rates suggests that costs can be reduced below the reasonable level needed to provide adequate service to customers. Furthermore, Staff asserts, ratepayers are entitled to cost controls, improved efficiencies, and customer service enhancements as a part of reliable, safe, and adequate utility service.

According to Staff, the Company's arguments regarding its own wage expense compared to that of other utilities is irrelevant. Instead, the reasonableness of CIWC's own costs is the relevant issue. To that end, Staff asserts that the Company did not provide sufficient evidence that its incentive compensation program increases efficiencies and reduces costs, consistent with the Commission's Orders in 02-0690 and other dockets.

b) Company Position

Consistent with its practice as well as with past Commission Orders, the Company included incentive compensation expense of $48,720 as an amount it seeks to recover in rates. Staff Witness Smith proposes to eliminate the Incentive Compensation expense. The Company views Mr. Smith's testimony to suggest that employees should not receive bonuses, and compensation should be reduced if the level of performance is not adequate.

In support of its position, CIWC states that it has paid incentive compensation since 1995, and does so to motivate its employees to achieve efficiencies, cost reductions, and service enhancements. The Company also asserts that the payment of incentive compensation is not driven solely by earnings performance, but also by certain service-oriented goals.

Examples of targets set by the Company include maintaining or reducing operating costs at or below budgeted levels; not incurring any regulatory violations; maintaining accident and illness incidents below the water utility average; reducing the level of unaccounted-for water; reducing the number of water quality inquiries and complaints from the number received in the previous year; implementing all security recommendations; and devising strategies to protect the watershed. While CIWC acknowledges that some of these goals relate to earnings in part, it emphasizes that the proportionally larger benefit accrues to ratepayers.

In response to a concern raised by Staff, CIWC points out that, even if incentive compensation were withheld due to an unacceptably high cost, the funds collected for incentive compensation would be redirected to offset that cost. In that situation, the money collected from ratepayers would be used to mitigate the cost spike. The Company asserts that such an allocation minimizes any potential rate shock, and in any event does not flow to investors.

Similarly, the Company explains that Staff's presumption that costs cannot be reduced after the conclusion of a rate proceeding erroneously assumes that financial and operating conditions will remain static throughout the life of the rates. As an example, the Company points out that its present return on equity has fallen to 7.36%, from 10.15% authorized in 2001. By extension, CIWC suggests, incentive compensation encourages ongoing self-assessment and adaptation in the face of such change, thereby reducing the magnitude and frequency of rate cases. Accordingly, the Company urges the Commission to reject Staff's proposal.

c) Commission Conclusion

The Commission notes that it has sometimes granted and sometimes denied recovery of incentive compensation in recent rate cases. Generally, a determination was made on the facts of the case under consideration. (See, e.g., Order, 02-0837 (Oct. 17, 2003), at 26 (recovery "may be appropriate in some circumstances"); Order, 02-0690 (Aug. 12, 2003), at 19, citing Order, 00-0802 (Feb. 20, 2002), at 19 (recovery permitted where incentive compensation "can reasonably be expected to provide net benefits to ratepayers"); Order, 01-0696 (Sep. 11, 2002), at 10 (requiring evidence of "specific dollar savings or any other tangible benefit for the ratepayers").)

Even CIWC experienced various outcomes on the issue. Recovery was denied at the outset of the program due to the speculative amount and lack of payment history. (See Order, 95-0307/95-0342 (cons.) (May 8, 1996), at 26 [unmodified by subsequent Orders in that Docket].) In the subsequent 1997 rate case, recovery of incentive compensation was approved by the Commission. (Amended Order, 97-0351 (June 17, 1998), at 16.) In the 2000 rate case, which was settled upon agreement of the parties, CIWC received incentive compensation subject to an adjustment proposed by Staff. (Order, 00-0337/00-0338/00-0339 (cons.) (Jan. 31, 2001), at 5.)

The Commission reiterates that, to recover incentive compensation, the plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates.

Under this rubric, the Commission concludes that the incentive compensation costs should be recovered by CIWC. The Commission notes that many of the objectives can be measured by tangible or quantifiable results, and expects detailed evidence of the same to be presented in future cases if the issue arises.

As a whole, the program appears to set targets for a broad range of objectives, rather than tying compensation directly to earnings performance. Many of the goals established by the Company promote ever-increasing water quality and system safety. While investors may derive some benefit from certain cost reduction goals, the Commission is of the opinion that ratepayers are the primary beneficiaries of the incentive compensation program as a whole. Accordingly, the Commission concludes that it is reasonable for the cost of incentive compensation to be recovered in rates. The adjustment proposed by Staff, therefore, is not adopted.

4. Charitable Contributions Expense

a) Staff Proposal

Staff proposes to reduce the Company's proposed revenue requirement by disallowing the community and economic development organization fees that have been included by the Company as charitable contributions. Staff asserts that this proposal is identical in reasoning to its reduction of industry association dues by the amounts paid to community and economic development organizations rather than to industry associations. Staff witness Sant testifies that donating to community and economic development groups is not necessary to providing utility service. Instead, it is a promotional and goodwill practice, for which the ratepayers should not be responsible.

Staff asserts that CIWC's argument, that the contributions are not burdensome to customers and are beneficial to the community, fails to address Staff's contention that such donations comprise a promotional and goodwill practice not necessary to providing utility service. Also, in Staff's view, CIWC fails to give persuasive reasons why the Commission should differ from its consistent position of disallowing such expenses from the revenue requirement. Furthermore, according to Staff, the Company fails to provide any reasoning for accepting Staff's adjustment to Industry Association Dues but not to Charitable Contributions.

According to Staff, CIWC also argues that, since donations to economic development and community organizations are not dues, they are recoverable as charitable contributions. In response, Staff contends that the Commission has previously determined that, "while companies should interface with these kinds of groups, the shareholders should bear the cost." (Staff Reply br. at 10, citing Order, 90-0169, March 8, 1991, at 65-66; see also Orders cited, Staff ex. 1.0 at 9.) Staff also disagrees with the Company that prior Commission Orders cited in Staff testimony are irrelevant because those Orders address dues rather than contributions. Even assuming these costs are something other than dues, Staff argues, costs in addition to dues should not be recoverable if the dues themselves are not recoverable. Staff further states that CIWC acknowledges that the contributions support the normal operations of the recipients. Staff emphasizes that the support of normal operations is determinative, and not the label of "dues" or "contributions."

Staff also attacks CIWC's assertion that the contributions are recoverable, pursuant to Section 9-227 of the Act. According to Staff, whether the amounts in question are dues or contributions, the Company failed to demonstrate that they are for scientific, religious, or educational purposes. For these reasons, Staff asserts that the Commission should adopt its proposal to disallow certain fees paid to community and economic development organizations under the guise of charitable contributions.

b) Company Position

The Company asserts that its charitable contributions should be fully included in test year expense. The standard for allowance of donations, CIWC asserts, is governed by Section 9-227 of the Act, which provides that:

> It shall be proper for the Commission to consider as an operating expense, for the purpose of determining whether a rate or other charge or classification is sufficient, donations made by a public utility for the public welfare or for charitable scientific, religious or educational purposes, provided that such donations are reasonable in amount. In determining the reasonableness of such donations, the Commission may not establish, by rule, a presumption that any particular portion of an otherwise reasonable amount may not be considered as an operating expense. The Commission shall be prohibited from disallowing by rule, as an operating

> expense, any portion of a reasonable donation for public welfare or charitable purposes.

220 ILCS 5/9-227. Accordingly, the Company explains, the issues are whether the donation advances charitable scientific, religious, or educational purposes; and whether the contributions are reasonable in amount.

The Company states that Staff recommends the elimination of $9,867 of the $49,267 of charitable contributions included by the Company in the cost of service. According to CIWC, Staff's adjustment assumes that interaction with community and economic development organizations is a promotional and goodwill practice not necessary for the provisions of utility service, and is synonymous with charitable contributions to community and economic development organizations. The Company asserts that Staff disallows recovery of dues paid to community and economic development organizations within the adjustment to Industry Association Dues, and now it attempts to extend that adjustment to charitable contributions donated to the same types of organizations. Furthermore, CIWC argues, the cases cited by Staff address dues paid either to professional societies or community and economic development organizations. Either way, the Company contends, they do not address charitable contributions, and therefore are not on point.

The Company believes that its contributions to community and economic development agencies, at about 0.4% of its revenue, are reasonable in amount. It also points out that Staff has not argued that the amount of donations is unreasonable. Moreover, the Company believes that such contributions benefit ratepayers, especially in light of economic weakness in the service area. In response to Staff's argument that the contributions are unnecessary and promotional, CIWC asserts that it operates in a wholly regulated market and has no reason to promote its image. Instead, the Company argues that its donation of less than $10,000 is intended to enhance the image of the community served by the Company, which could result in the attraction of additional industries.

c) Commission Conclusion

The Commission concurs that the language of Section 9-227 of the Act, cited by CIWC, is on point. Ultimately, however, the Commission concludes that the Staff's adjustment to reduce charitable contributions should be adopted.

The Commission is not willing to blur the distinguishable categories of industry dues and charitable contributions. The Order entered in 90-0169 squarely places the costs for industry association dues on the shareholders. See Order, 90-0169, at 65. With respect to charitable contributions, however, the Commission analyzed the reasonableness of the proposed contributions and assigned the value to be recovered in the cost of service based on the facts of the case. See id.

The Commission refined its reasonableness test in Docket 94-0065, ruling that:

> The determination of the reasonableness of a utility's contributions results in a finding of fact based on the Commission's judgment. …. The utility has the burden [to] support its claim of reasonableness. No presumption exists that donations made by a utility are reasonable.

Order, 94-0065 (Jan. 9, 1995), at 38-39. Based on the foregoing, it is clear that the Commission will examine the facts presented in the record to make its determination. The Commission declines to view other Orders adopting the respective parties' agreed resolution of the issue (including adoption of an adjustment) to either contradict or revise this reasonableness test.

This framework is readily applicable to the issue at hand. Section 9-227 permits recovery if the donations are made "for the public welfare or for charitable scientific, religious or educational purposes [and] are reasonable in amount." See 220 ILCS 5/9-227. Staff correctly points out that the donations at issue are not for "charitable scientific, religious or educational purposes." Instead, they are for community or economic development associations.

The Company still could prevail, however, if those donations are made "for the public welfare" and are reasonable. Company Schedule C-7 lists the recipients and amounts of the contributions. Whether the amounts in question actually are contributions for the public welfare has not been established. The burden to provide that evidence is upon the utility. With only the basic information contained in Schedule C-7 and Company testimony regarding other donations, the Commission lacks sufficient evidence to determine that the contributions to the community and economic development organizations are properly within the scope of Section 9-227. Accordingly, the Commission concludes that the amounts in question should be excluded from the cost of service in this case. (Cf. Order, 02-0690 (Aug. 12, 2003), at 21 (disallowing recovery of donations "which may or may not be allowable under the Act, but [due to the] lack of evidence, cannot be determined as such"). Accordingly, Staff's proposed reduction to charitable contributions is accepted.

5. Advertising Expense

a) Staff Proposal

Staff proposes to disallow the portion of advertising expense that is attributable to goodwill advertisements. Staff asserts that the Company failed to produce evidence of the costs for the advertisements. As a proxy, Staff estimated the cost of goodwill advertising as the product of total advertising expense and the ratio of goodwill advertising scripts to the total number of advertising scripts provided by the Company.

According to Staff, CIWC acknowledges that several of the advertisements that Staff identifies are indeed goodwill advertisements, but neither identifies which advertisements it concurs are goodwill, nor their actual costs. Although CIWC argues that several others are proper charitable contributions rather than advertisement expenses, Staff contends that its proposal is based upon a ratio that is not refuted in the record, and does not disallow particular advertisement expenditures.

Furthermore, Staff argues, placing program ads is not equivalent to providing donations, because the Company receives advertising services for its payments. To classify those expenses as charitable contributions rather than as advertising is flawed both in principle and in its failure to reflect the Company's own actions and accounting records.

Staff also charges that the Company mounted its argument against Staff's adjustment late in the process, and failed to provide all of the advertising scripts sought by Staff for evaluation. Nevertheless, Staff states that the particular advertisements at issue in the adjustment were identified in Staff ex. 5.0, Schedule 5.07, at 2 n.4.

Staff further avers that the Commission should ignore the argument that Staff confuses the advertisement campaigns of large utility companies with CIWC's reasonable donation to charity. According to Staff, the Company does not explain why the size, rather than the nature, of an advertising campaign should determine whether its costs are recoverable. The advertisements are not simply charitable donations, Staff argues, because CIWC received the benefit of goodwill in exchange for underwriting the cost of the advertisements at issue.

Alternatively, the Company's charitable donation argument, applies at most to a small portion of the adjustment proposed by Staff. The amount of advertising expense the Company attempts to reclassify as charity is only $1,885 of the $18,667 in total advertising expense. After application of the ratio by which the adjustment is calculated, Staff states that its disallowance of the allegedly charitable advertisements amount to only $1,172 of the total adjustment of $11,491. Even if the charitable donation argument is accepted, Staff contends that the remaining $10,319 should still be disallowed.

b) Company Position

The Company asserts that its full advertising expense should be included in the cost of service. Staff's proposed adjustment to trim $11,491 should not be adopted, because that amount fits within the terms of Section 9-227 of the Act.

CIWC asserts that, to calculate its adjustment, Staff assumes that the same ratio of goodwill advertising to total advertising exists in this case as in its previous rate case. The Company doubts that Staff can identify the particular advertisements alleged to be for goodwill, or the costs attributable thereto. Accordingly, CIWC avers that Staff's arguments in support of its adjustment only amount to unsupported inferences.

The result of the adjustment, CIWC contends, is to eliminate its recovery of the cost of advertisements that are donations for public welfare and for educational purposes. As a result, the Company asserts that the costs should more appropriately be analyzed as donations, pursuant to Section 9-227 of the Act. The Company emphasizes that the proposed adjustment disallows the expense of program advertisements underwritten on behalf of causes such as the Kankakee School District, Illinois Seniors, Bishop McNamara High School and Bradley Victims Assistance Association.

The Company notes that Staff adopts the definition and treatment of goodwill advertising specified in Section 9-225 of the Act. That Section, CIWC avers, primarily applies to energy utilities and not to small water companies. Furthermore, the Company emphasizes that the focus of Section 9-225 is to prevent the recovery of advertising costs that primarily promote the image of the utility rather than, as here, lend charitable support to local non-profit organizations.

Finally, CIWC disputes Staff's contention that it did not object to the adjustment in a timely manner. The Company explains that it did, in fact, present its disagreement in rebuttal testimony, and cites to CIWC Ex. R-2.0 at 8-9.

c) Commission Conclusion

The Commission disagrees with Staff that certain arguments on the issue were not timely made. The Commission agrees, however, that the costs of goodwill advertising should not be recovered in rates. Furthermore, the Company has the burden to provide the appropriate evidence demonstrating the particular nature and cost of the advertisements sought to be recovered. In the absence of such evidence, it is proper for Staff to apply a ratio to estimate the costs that are not recoverable.

The Commission also agrees with Staff that advertisements and charitable contributions are not equivalent. The Commission finds the language of Sections 9-225 and 9-227 helpful in distinguishing the categories. Even if Section 9-225(1)(d) is not directly aimed at CIWC, it demonstrates that the purpose of goodwill advertising is to improve the image of the utility. Section 9-227, on the other hand, emphasizes the public welfare and scientific, religious, or educational purpose of a donation. In this case, printed advertisements bear the utility's name as a supporter of an organization or event in a manner designed to generate goodwill and display the neighborliness of the utility. Such purpose is not within the scope of Section 9-227.

Advertisements and charitable contributions are different types of transactions, and simply mixing their labels does not support their recovery in rates. The need to maintain clear and proper accounting records is highly important. For these reasons, the Commission concludes that Staff's proposed adjustment in the amount of $11,491 is proper.

6. Rate Case Expense

a) Staff Proposal

Staff proposes to decrease the estimate of rate case expense from $195,000 to $167,424. Mr. Sant proposed this adjustment because the Company's estimate represented a 26% increase over the estimate in the previous rate case, and the previous rate case expense estimate was 14% larger than that ultimately incurred. Staff also argues that the Company failed to support its estimate and update its projected expense.

Although Staff agrees that the Company has provided support for its costs of $120,878 through October 31, 2003, it takes issue with the estimated balance of $74,122 from November 1, 2003, to the completion of the case. Staff opines that it is unlikely that the Company will expend the exact amount it originally projected. Company witness Schreyer testified that its rate case expense incurred through the end of November, 2003, had grown to $150,181; Staff contends that this testimony is unsupported. Furthermore, Staff argues that the provision of a cost amount at a particular point in time does not serve to support the overall estimated amount. Staff additionally asserts that CIWC failed to answer its requests for updated projections of its rate case expense comparing actual and projected expenses at different points within the proceeding.

Staff highlights that its proposal to include $167,424 is greater than the estimated amount of $155,000 in CIWC's prior rate, Docket 00-0337, and greater than the $133,000 actual incurred in that Docket. Staff acknowledges that, all else being equal, a settled case would likely cost less than a fully litigated case. Staff maintains, however, that the Company's projection of $195,000 is no more valid than Staff's calculation of $167,000.

b) Company Position

The Company asserts that its estimated rate case expense of $195,000 is reasonable, and should be fully included in the cost of service. According to CIWC, Staff proposes its adjustment because the Company's estimate of rate case expense was too high in the previous rate case; therefore, the Company's claim in the current case must also be too high. CIWC emphasizes that Staff witness Sant does not allege that the claimed rate case expense is unreasonable, and ultimately admits that he has no basis for claiming that the estimate is unreasonable. CIWC contends that the core of the proposed adjustment is an assumption that the rate case expense sought in this case is an overestimate proportionate to that in the previous rate case.

The Company argues that Staff fails to consider that the previous rate case settled, while the instant case is being litigated. Accordingly, CIWC argues, the rate case expense will increase. Mr. Schreyer testified that CIWC's actual rate case expense was $120,878 through October 31, 2003, and $150,181 through November 30, 2003. Even after the Company had incurred $150,181 in rate case expense, several activities still remained to be completed, including preparation for and participation in the evidentiary hearing as well as briefing. CIWC also argues that Staff's demand for comparisons between actual expenses and projected expenses assumes a level of certainty to a rate case expense estimate that does not exist.

c) Commission Conclusion

The Commission declines to adopt Staff's adjustment to rate case expense. Although the rise in both the estimated and actual rate case expense figures is worthy of examination, the Company correctly points out that the difference is due, at least in large part, to the fact that the previous case settled while the instant case is being fully litigated.

Staff's arguments that the Company failed to provide updated information also are unpersuasive. Staff agrees that the Company established that its actual costs were $120,878 through October, 2003. Also, Mr. Schreyer testified that actual costs rose to $150,181 by the end of the following month. Although it labels this testimony as unsupported, Staff did not counter it successfully. Additionally, the Company necessarily incurred costs preparing for and participating in the evidentiary hearing, as well as in drafting post-hearing briefs.

The Commission appreciates that the determination of rate case expense involves estimation. At the same time, the Commission is mindful that rates set in this Docket must be just and reasonable, as Section 9-101 of the Act requires. By extension, the components of those rates, including rate case expense, must themselves be just and reasonable. The Commission, faced with the choice of the two figures offered by the parties, is satisfied that the evidence shows that CIWC's estimate is reasonable, and is more likely to be observed than the estimate offered by Staff. For these reasons, the Commission concludes that Staff's adjustment should not be adopted.

D. Approved Operating Revenues, Expenses, and Income

Giving effect to the adjustments approved above and the rate of return on original cost rate base authorized hereafter in this order, 8.87%, the Commission concludes that CIWC's operating income statement for the test year and for purposes of this proceeding is as follows:

Approved Operating Income Statement

Operating Revenue	$ 12,802,976
Miscellaneous Operating Revenues	274,146
QIP Revenue	-
Total Operating Revenue	13,077,122
Uncollectibles Expense	41,587
Salaries & Wages	1,824,207
Pensions & Benefits	667,594
Purchased Power & Fuel	392,449
Chemicals	316,619
Materials & Supplies	187,690
Contractual Services	1,599,132
Lease Expense	18,185
Transportation Expense	155,196
Insurance Expense	231,261
Regulatory Expense Amortization	65,917

Miscellaneous Expense	193,321
Depreciation Expense	1,854,223
Amortization	(50,734)
Taxes other than Income	659,981
Total Operating Expense Before Income Taxes	8,156,628
State Income Tax	242,281
Federal Income Tax	1,096,239
ITCs Net	(21,276)
Total Operating Expenses	9,473,872
Net Operating Income	$ 3,603,250

The operating income statement reflects the revenue increase of $2,579,278, or 24.57%, which is authorized in this Order.

IV. RATE OF RETURN

A. Introduction and Capital Structure

The Company and Staff agree that the appropriate capital structure for determining the rate of return is as follows below:

Category of Capital	2004 Future Test Year Balance	Percent of Total Capital
Short-Term Debt	$ 395,833	0.37%
Long-Term Debt	52,340,300	48.22%
Preferred Stock	382,797	0.35%
Common Equity	55,429,929	51.06%
Total	$ 108,548,859	100.00%

They also agree that CIWC's preferred stock comprises $382,797, or 0.35% of the capital structure in the 2004 future test year, at a cost rate of 5.48%; that long-term debt comprises $52,340,300 in the 2004 future test year capital structure, or 48.22%, at an embedded rate of 7.90%; and that common equity comprises $55,429,929 of capital structure or 51.06% during the 2004 future test year. Staff and CIWC disagree, however, on the proper cost of common equity.

B. Common Equity

1. Company Position

The Company recommends that the Commission adopt a return on common equity of 10.75%. It states that its witness, Ms. Ahern, has provided testimony supporting a 12.50% return on common equity, but CIWC is pursuing the lower rate in an effort to mitigate rate shock to customers and controversy surrounding the increase.

Also, Company witness Bunosky points out that CIWC anticipates investment of $12.5 million in utility plant in 2003 and 2004. Much of that investment will be used to replace aged infrastructure already in place, and will not generate new revenue. Such investment instead reflects risk inherent to the industry, CIWC asserts, such that regulatory and legislative initiatives may mandate additional investment in plant.

All of the common shares of CIWC are held by Consumers Water Company and are not publicly traded. Market data is therefore not available for CIWC, so Ms. Ahern selected two proxy groups to determine a fair rate of return on common equity. One proxy group ("Water group") consisted of seven water companies included in the Water Company Group of C.A. Turner Public Utility Reports (April 2003) listed with either Value Line (Standard Edition) or Thomson FN/First Call Consensus. The second group ("Utilities group") consisted of thirteen utilities with comparable risk to CIWC, based on a measurement of least relative distance across the following eight parameters: pretax interest coverage; common equity ratio; fixed asset turnover; the percentage of AFUDC to net income; cash flow as a percentage of permanent capitalization; the ratio of net cash flow to expenditures; interest coverage based on funds flow; operating earnings stability.

Ms. Ahern bases her recommendation on the results of several financial models, including the discounted cash flow model ("DCF"), risk premium model ("RPM") capital asset pricing model ("CAPM") and a comparable earnings model ("CEM"). Each of these models are based upon the Efficient Market Hypothesis ("EMH"), which states that investors are aware of all publicly available information, assess perceived common stock risks noted therein and take those risks into account in the prices they pay for securities. The Company asserts that, in order for the Commission to most closely model investor behavior, no single common equity cost rate model should be relied on. Instead, the results of multiple models should be taken into account.

a) Discounted Cash Flow Model

The Company explains that the DCF model estimates the present value of an expected future stream of net cash flows during the investment holding period, discounted at the cost of capital or capitalization rate. The capitalization rate is the total return rate anticipated by investors, expressed as the sum of a representative dividend yield plus a growth rate to capture investors' expectations of future increases in cash dividends.

Ms. Ahern estimates the average dividend yields at a spot date of April 30, 2003, as well for the three, six, and twelve months ended April 30, 2003. Using this data, she estimates average yields of 3.3% for the Water group and 5.1% for Utilities group. Ms. Ahern adjusts these figures to recognize investors' expectations that the dividend will increase at some point during the ensuing four calendar quarters, resulting in dividend yields of 3.4% for the Water group and 5.2% for the Utilities group.

Once the dividend yield is calculated, the proper growth rate must be developed. Ms. Ahern reviewed historical dividends per share ("DPS"), earnings per share ("EPS") performance, the sum of internal and external growth in per share value ("BR + SV"), as well as published earnings and dividends growth rate forecasts. From this, she concludes that the appropriate prospective growth rates are 5.7%/7.2% for the Water group and 4.6%/6.1% for the Utilities group. When combined with adjusted dividend yields, Ms. Ahern's proposed growth rates produces DCF results of 9.1%/10.6% for the Water group and 9.8%/11.4% for the Utilities group.

In response to Staff's contentions that CIWC's growth rate conclusion is uninformative due to improper weighting, both among models and due to missing data in particular models, the Company responds that it assumes that missing data points are equal to the mean for the proxy group. This, CIWC asserts, is consistent with the idea of the EMH that investors use all available information. Also, the Company notes, it is not inconsistent with the use of proxy groups to estimate the common cost of equity for CIWC, which lacks market data.

Ms. Ahern also applies the DCF to model quarterly dividend payment, rather than annual payment as the traditional DCF Model assumes. She again uses spot dividend yields as of April 30, 2003, as well as average dividend yields for the three, six and twelve months ended April 30, 2003, consistent with her annual DCF Model. She also uses growth rates for each company based on historical and projected growth in DPS, EPS, and BR plus SV, as well as based upon average projected growth in DPS and EPS. The Company asserts that these estimates are calculated identically to the average growth rates used in the annual DCF Model. The results of the quarterly DCF Model are 9.6%/10.8% for the Water group and 9.6%/11.3% for the Utilities group.

Finally, Ms. Ahern concludes from her models that the DCF cost rate results based upon both the single-stage DCF and the quarterly DCF are 10.1% for the Water group and 10.7% for the Utilities group.

b) Risk Premium Model

The second model that Ms. Ahern uses is the RPM. She starts with the prospective yield on Moody's A2-rated public utility bonds of 7.2% and equity risk premiums of 5.25% for the Water group and 5.5% for the Utilities group. The utility bond yield of 7.2% derives from the average expected yield on Moody's Aaa-rated corporate bonds, which is itself based on the May 1, 2003, Blue Chip Financial Forecasts consensus forecast of the expected Aaa-rated corporate bond yield for the six calendar quarters ending with the third quarter of 2004, adjusted to reflect a Moody's A2-rated public utility bond yield. The equity risk premiums derive from Ms. Ahern's own analysis of historical and projected equity risk premiums. Ms. Ahern concludes that the cost of equity using the RPM approximated 12.4% for the Water group and 12.7% for the Utilities group.

The Company rejects Staff's assertions that its RPM analysis is inappropriate based on its use of both historical data and S&P's Public Utility Index. CIWC maintains that the use of historical data in this context is indeed appropriate, as discussed below. The Company also asserts that the risk of the S&P Public Utility Index is comparable to that of CIWC. Ms. Ahern derives an equity risk premium based on S&P's Public Utility Index that was applicable to a utility with A-rated public utility bonds. Such an equity risk premium, according to the Company, is consistent with Ms. Kight's imputed A+ bond rating for CIWC. Therefore, CIWC reasons, the equity risk premium derived from the S&P Public Utility Index indeed is appropriate for arriving at a common equity cost rate for CIWC.

c) Capital Asset Pricing Model

Ms. Ahern also employs the CAPM, in which the expected common equity return is determined by adding a risk-free rate of return and a market premium that is proportional to the non-diversifiable risk of a particular security. Non-diversifiable risk, CIWC explains, is measured using a "beta" value, which indicates the risk of an individual stock relative to that of the entire market. A beta less than 1.0 indicates lower risk, while a beta greater than 1.0 indicates greater risk than the market.

The Company contends that Ms. Kight calculates her own estimates of beta, rather than using widely-available Merrill Lynch betas. Also, CIWC asserts, Ms. Kight bases her calculation on the NYSE Composite Index and not the S&P 500. The Company contends that such calculations are unnecessary.

Ms. Ahern asserts that the proper risk-free rate of return is the long-term U.S. Treasury Bond ("T-Bond") yield, because it best represents the long-term investment horizon implicit in utilities' common stocks. Ms. Ahern uses a risk-free rate for both the Water group and the Utilities group of 5.4%, based on the average consensus forecast reported in the May 1, 2003, Blue Chip Financial Forecasts of the expected yields on long-term U.S. Treasury bonds for the six quarters ending with the third calendar quarter on 2004. Ms. Ahern adds beta-adjusted market premiums to this risk-free rate, based upon the traditional CAPM and empirical CAPM ("ECAPM") results, to derive CAPM equity cost rate results of 12.3% for the Water group and 12.9% for Utilities group.

With respect to this analysis, CIWC disputes Staff's argument that the use of adjusted betas transforms a traditional CAPM analysis into an ECAPM model. The Company suggests that such argument implies confusion between the concepts of beta, the risk of an individual stock relative to the market, and the slope of the security market line ("SML"), which reflects the degree of risk aversion in the economy.

d) Comparable Earnings Model

The next model in Ms. Ahern's analysis is the CEM. Although the CEM examines returns on book value, Ms. Ahern asserts that her application of the CEM is market-based because the selection of non-price regulated firms of comparable risk is based on statistics derived from the market prices paid by investors. It is appropriate to use the CEM to determine common equity cost rates, the Company contends, because the Supreme Court has articulated that, in setting just and reasonable rates:

> [T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Federal Power Com. v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944); see also Bluefield Waterworks & Improvement Co. v. Public Service Commission, 262 U.S. 679 (1923).

For purposes of her analyses, Ms. Ahern selects two proxy groups of non-price regulated companies, chosen on the basis of ranges of unadjusted beta and residual standard error. She then examines the returns on book common equity, net worth, or partners' capital for the companies in each group. The resulting CEM cost rates are 15.0% for the Water group and 16.3% for the Utilities group. Next, Ms. Ahern adjusts the results by eliminating from both of the proxy groups any company whose rate of return is greater than 20.0% or less than 7.2%, the prospective yield on Moody's A rated public utility Bonds. Such adjustments resulted in an arithmetic mean historical five year and projected five year rates of return of 13.6% and 13.3%, for the Water group and the Utilities group respectively.

e) Business risk adjustment

The Company asserts that, because of its small size and its commensurate additional business risk, it faces a higher common equity cost rate. To account for CIWC's small size, Ms. Ahern adjusts her initial 12.1% and 12.4% common equity cost rates by 0.25% for the Water Company Group and 0.35% for the Utilities group. This adjustment produces rates of return on equity of 12.35% and 12.75%, respectively. The mid-point of this range produces her recommended cost of equity of 12.5%.

Staff's asserts that CIWC fails to support its size premium. The Company contests this, and points to its discussion of a study by Ibbotson Associates. The Company asserts that the study, while not restricted to utilities, is as relevant to CIWC as Staff's use of market data for choosing groups of utilities based upon comparable risk. Because common stock for CIWC is not publicly traded, the Company reasons, a market-based common equity cost rate applicable to CIWC must be derived from the market data of firms of comparable risk. Moreover, the companies in both Ms. Ahern's and Ms. Kight's proxy groups are included in the Ibbotson Associates study. Therefore, CIWC concludes, the study is relevant. The Company also offers for further support a description of the alleged effect of small firm size on relative risk from a finance text.

f) Recommendation

Based on her models, Ms. Ahern concludes that the appropriate common equity cost rate allowance for the Company is 12.50%. This figure represents the average of her results for the Water group and Utilities group, each of which is the adjusted average of the results from her four financial models.

	Water group	Utilities group
Discounted Cash Flow Model	10.1%	10.7%
Risk Premium Model	12.4	12.7
Capital Asset Pricing Model	12.3	12.9
Comparable Earnings Model	13.6	13.3
Average	12.1	12.4

Business Risk Adjustment	0.25	0.35
Common Equity Cost Rate After Adjustment for Business Risk	12.35%	12.75%
Recommended Common Equity Cost Rate	12.50%	

In light of these results, the Company urges the Commission to accept its analysis, and adopt a rate of 10.75% for the cost of common equity. It supports this lower figure to mitigate both the potential for rate shock to customers and the controversy of the rate increase.

Staff asserts that its cost of capital recommendation implies a pretax interest coverage of 3.2x for CIWC, which is within the range of 2.8x – 3.4x that S&P has established for companies with an A rating and business position of 3. According to CIWC, a recommended cost of capital provides an opportunity for pretax interest coverage before the impact of attrition, which decreases the actual pretax interest coverage implicit in a cost of capital recommendation. The Company suggests that the adoption of Staff's recommended cost of equity would cause CIWC's actual pretax interest coverage to fall below 3.2x. The Company points out that its own requested cost of capital rate of 9.52% (the result of a 10.75% cost of common equity) also results in pretax interest coverage of 3.37x, which is within the range of 2.8x – 3.4x.

g) Further Criticisms of Staff's Analysis

(1) Staff's Equity Cost Recommendation

Staff witness Kight recommends a common equity cost rate of 9.86%, which CIWC contends grossly understates its current and prospective costs of equity. First, the Company compares the results of its 2000 rate case and the instant proposal with the results of the 2000 and 2003 rate cases for Illinois American Water Company ("IAWC"). It asserts that, in the 2000 cases, the cost of common equity was set at 10.15% and 10.17% for CIWC (00-0037, Jan. 31, 2001, at 7) and IAWC (00-0340, Feb. 15, 2001, at 25) respectively. In the 2003 cases, however, CIWC views Staff's recommendation of 9.86% as a sharp contrast to the outcome of 10.27% for IAWC (02-0690, Aug. 12, 2003, at 82). While the cost of equity granted to IAWC rose 10 basis points since 2000, the same cost contemplated for CIWC is 29 points less.

The Company asserts that Staff witness Kight's estimation of CIWC's hypothetical credit rating is at the core of this issue. The flaw, CIWC contends, is that Ms. Kight ignored CIWC's actual rating of NAIC-2 by the National Association of Insurance Commissioners ("NAIC"), and instead compared CIWC to a sample group of companies with Standard & Poor's ("S&P") debt ratings of AA, AA-, A+, A or A-. An NAIC-2 rating, CIWC asserts, corresponds instead to an S&P rating of BBB. Furthermore, the Company argues that developing an S&P rating involves much more than comparing certain financial ratios, and it questions whether Staff's witness has the necessary knowledge and experience to make such a determination.

The Company also criticizes Staff for relying solely on the assessment of S&P in building her sample. It asserts that this technique is inconsistent with Staff's independent estimation of betas, rather than using available Merrill Lynch betas. The Company also asserts that its quantitative evaluation of a general utility sample for risk, by evaluating the least relative distance to CIWC, leads to a superior sample. Additionally, the impact of recent restructuring in the industry would be eliminated from the sample, because the data from such firms would not fall within the least relative distance.

The Company also asserts that the public utility bond yields in October, 2003, averaged 6.43% for those with a Moody's rating of A, and 6.79% for those rated Baa. The Company asserts it has a bond, or credit, rating equivalent to Moody's Baa or S&P's BBB. Accordingly, CIWC recommends that the 36 point difference between 6.43% and 6.79% should be applied to Ms. Kight's recommended common equity cost rate, resulting in a 10.22% rate. The Company additionally points out that this does not account for CIWC's business risk.

(2) Staff's Exclusive Reliance on the DCF

No single cost of equity model is so inherently precise that it can be relied upon to the exclusion of all other methods, CIWC asserts. The Company contends that, while Ms. Kight ostensibly uses a Risk Premium Model as well, hers is dependent on the DCF model to the point of essentially exclusive reliance on it. According to CIWC, she offers no separate independent model to corroborate the results of her application of the DCF to the market data of her groups of comparable companies. Also, the Company posits, this methodology ignores the tenet of the EMH that investors are aware of, and use, all publicly available information regarding a Company.

The Company also contends that Staff's CAPM understates the cost of common equity, because Ms. Kight estimates the market equity risk premium by DCF analysis. When the market to book ratios significantly exceed 1.0, as is the case currently, CIWC asserts that the DCF model mathematically understates investors' required rate of return.

Furthermore, the Company alleges that Staff is incorrect to state that its DCF estimate of R_M, at 13.66%, is higher than the 12.4% estimate of R_M that Ms. Ahern calculated from historic, non-DCF data. CIWC asserts that the proper comparison is to the forecast market return of 18.62% based upon the Value Line of 18.62%. Based on this comparison, CIWC contends that Staff's estimate of R_M is grossly understated due to a DCF bias.

The Company argues that other regulatory commissions have questioned the reliability of the DCF method given current market fundamentals. (See, e.g., Indiana American Water Company (1994), 150 P.U.R.4th 141; 1994 Ind. PUC Lexis 107, *79 ("if the traditional DCF model is strictly applied to an original cost rate base, the investor could earn the cost of capital only if the investor paid no more than book value for the stock.").)

According to CIWC, Ms. Kight's use of spot prices in her DCF model magnify any market aberrations. The Company contends that it is improper to use stock price on a certain date, rather than over a historical period, to determine her dividend yields without evidence that market conditions on that date were not aberrational. Company witness Ahern contends that recent mergers and acquisitions in the industry have affected the common stock prices of all water utilities in the market. Accordingly, spot prices reflect the market perception of the current value of common stocks, but do not reflect accurately the cost rate of common equity on an ongoing basis.

Furthermore, the Company distinguishes between the Value Line-based estimate of the market rate of return and the DCF dividend growth rate. Although Staff criticizes this distinction, Ms. Ahern explains that the dividend growth rate is only a proxy for market price appreciation, while Value Line is a direct estimate of market price appreciation that is independent of DCF.

(3) Historical data

Staff argues that Ms. Ahern erred in improperly relying on historical data. The Company contends, however, that the use of historical data is consistent with the long-term investment horizon presumed by the DCF model. It reflects high, low, and moderate returns in both placid and volatile markets. CIWC cites a study by Ibbotson Associates (Stocks, Bonds, Bills and Inflation – Valuation Edition 2002 Yearbook) which suggests that, because historical patterns tend to repeat, long-run capital market return studies contain information useful in predicting future trends. Ms. Ahern asserts that the mean value in a series is the best estimate of the next expected value of randomly generated data. This includes series such as market returns and equity risk premia.

2. Staff Position

Staff witness Kight estimated the cost of common equity for CIWC with the DCF and risk premium models. Because the common stock of CIWC is not publicly traded, the DCF and risk premium models must be applied to samples of utilities of comparable risk. The first sample ("water sample") comprises seven market-traded water utilities within S&P's Utility Compustat database that were not in the process of being acquired by another company, and for which growth forecasts were available from either the Institutional Brokers Estimate System ("IBES") or Zacks Investment Research ("Zacks"). The second sample consists of eight public utilities selected from the S&P Utility Compustat database that matched CIWC's implied business profile score of 3 or stronger; had an S&P debt rating of AA, AA-, A+, A, or A-; were not in the process of being acquired by another company; and for which either IBES or Zacks growth forecasts were available ("utility sample").

Staff responds to the Company's criticism of its utility sample selection by pointing out that the Company did not object either to any of the companies present in the sample, or that the utility sample risk is dissimilar to that of CIWC. Ms. Ahern is correct that Staff has utilized a general utility sample selected on the basis of a quantitative comparison in risk to the petitioner in past rate cases. Staff explains, however, that recent industry restructuring has rendered questionable the measurement of financial and operating risk with historical data for many utilities. Since the selected sample must reflect both the operating and financial characteristics of CIWC, Staff relies upon S&P business profile scores, which measure operating risk, as well as credit ratings, which measure financial risk.

Ms. Kight estimates CIWC's operating risk from the average business profile score of all domestic water utilities rated by S&P. Ms. Kight then compares CIWC's financial ratios to the targets that S&P publishes, demonstrating that the Company has a financial strength consistent with an A+ corporate credit rating. By limiting the utility sample to companies with similar S&P credit ratings and business profile scores, the utility sample has similar exposure to financial and operating risk as CIWC. According to Staff, this is the same sample selection methodology the Commission accepted in Dockets 02-0690 and 02-0837. (See Order, 02-0690, at 78-79, 81; Order, 02-0837, at 32, 37.)

a) DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Ms. Kight applied a constant-growth quarterly DCF model, which properly accounts for the quarterly payment of dividends by the companies in the sample groups.

Staff states that DCF methodology requires a growth rate that reflects the expectations of investors. Ms. Kight measured the market-consensus expected growth rates with projections published by IBES and Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of August 11, 2003. Based on this growth, stock price, and dividend data, Ms. Kight's DCF estimate of the cost of common equity is 9.74% for the water sample and 9.75% for the utility sample.

b) Risk Premium Analysis

Staff explains that the required rate of return for a risky security equals the risk-free rate of return, plus a risk premium associated with that security. The risk premium methodology is consistent with investors' aversion to risk. Ms. Kight used a one-factor risk premium model, the Capital Asset Pricing Model, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification.

According to Staff, the CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. First, using Value Line beta estimates and regression analysis, Ms. Kight estimates forward-looking betas of 0.50 for the water sample and 0.595 for the utility sample.

Second, Ms. Kight considers two current estimates of the risk-free rate of return as of August 11, 2003: the 0.96% yield on U.S. Treasury bills and the 5.50% 30-year yield on U.S. Treasury bonds. Forecasts of long-term inflation and the real risk-free rate estimate that the long-term risk-free rate is between 5.7% and 6.0%. Accordingly, Ms.

Kight concludes that the U.S. Treasury bond yield is the superior proxy for the long-term risk-free rate in this analysis.

Finally, to measure the expected rate of return on the market, Ms. Kight conducted a DCF analysis on the firms composing the Standard & Poor's 500 Index. That analysis estimates that the expected rate of return on the market equals 13.66%. Using those three parameters in her risk premium model, Ms. Kight estimates the cost of common equity equals 9.58% for the water sample and 10.36% for the utility sample.

(1) Calculation of betas

In response to the Company's criticism that Ms. Kight computed beta directly rather than using betas readily available from Merrill Lynch, Staff responds that no tenet of financial theory suggests that it is inappropriate for an investor or analyst to calculate his own betas. Staff points out that the Commission has approved this approach in past rate cases. See, e.g., Order, 00-0340, at 25 ("The Commission finds Staff's calculation of betas reasonable. Staff has calculated sample betas in prior numerous rate cases.").

Staff also contends that, despite Ms. Ahern's assertion to the contrary, Ms. Kight did not have access to Merrill Lynch's published betas. She was able to reproduce them with Merrill Lynch's beta estimation methodology, however, resulting in adjusted beta estimates of 0.36 for Ms. Kight's water sample and 0.38 for her utility sample. Staff also states that Ms. Kight confirmed the accuracy of her Merrill Lynch beta estimates by comparing them to beta estimates calculated with the same methodology and published by Yahoo. Staff argues further that the Merrill Lynch and published Yahoo betas are lower than Ms. Kight's regression betas. As a result, the CAPM-derived cost of common equity estimate would be lower, rather than higher, if she were to include the Yahoo/Merrill Lynch betas in her CAPM analysis, either in addition to, or as a substitute for, her own betas.

(2) Exclusive reliance of DCF

Furthermore, Staff contests CIWC's allegation that its entire analysis relies exclusively on the DCF, simply because the market return used in her RPM was derived through a DCF calculation. First, Staff asserts, its RPM uses a DCF calculation only to derive the market return ("R_M"), which is one of its three inputs. Second, the R_M in Staff's RPM comprises 357 different companies not used in its DCF analysis. Third, Staff continues, the criticism is disingenuous because, in addition to using an historical return on the market, Ms. Ahern's own Risk Premium and Capital Asset Pricing models also estimate the rate of return required on the market with the DCF. According to Staff, both the Value Line and DCF-based estimates of the market rate of return amount to a dividend yield plus a growth rate. Finally, Staff posits that R_M, which is a forward-looking measurement, can only be estimated through a DCF calculation without resorting to untimely, obsolete historical data.

(3) Alleged Downward Bias in DCF Estimate

Staff disputes the Company's contention that the DCF estimate understates the cost of common equity when the market value of equity exceeds the book value. According to Staff, this could occur only if the investor-required rate of return has fallen or if expectations of future earnings have risen. The investor-required rate of return would fall if either the risk perceived by investors in the utility falls, or if the risk premium falls. Staff posits that, if the investor-required rate of return decreases, then the authorized rate of return should be lower as well.

Similarly, increases in investors' expectations of future returns could also cause a rise in market values over book values. Staff suggests that such expectations could come from results that exceed test year projections, or from earnings from sources outside the revenue requirement. Regardless of the cause, Staff argues, setting a rate of return on equity rate base in excess of the market required rate of return on common equity would lead to an upward spiral of increasing market value and rate of return.

Ms. Ahern also claims that the R_M used in Ms. Kight's RPM is grossly understated because the market value of the S&P 500 was much higher than its book value, so the results of Ms. Kight's RPM consequently are understated. According to Staff, this argument confuses required rates of return on market equity with expected rates of return on book equity. The market value of an investment, Staff explains, is an estimate of future earnings discounted at the required rate of return. The required rate of return is based on investors' time value of money and the assessed risk of the investment. If the required rate of return rises, all else equal, the price of an investment will fall. The converse is also true. Furthermore, Staff argues, the market price of a common stock does not achieve equilibrium until the expected rate of return on the common stock equals the investor required rate of return. In contrast, the book value of common stock does not respond to changes in the investor-required rate of return.

Staff also points out that its own 13.66% estimate of R_M is higher than the 12.4% estimate of R_M that Ms. Ahern calculates from historic, non-DCF data. Therefore, Staff concludes that the Company is incorrect to assert that Staff's estimate of R_M is grossly understated due to a DCF bias.

Finally, Staff argues that Orders cited by the Company from other jurisdictions in support of its arguments against the DCF are not binding. Staff's use of the DCF and CAPM models to determine a companies cost of equity has been approved by the Commission in numerous proceedings. (See Order, 02-0837, at 38; Order, 02-0690, at 81; Order, 02-0592, (Apr. 9, 2003), 6-7; Order, 00-0340, at 12, 24-25; Order, 00-0337/00-0338/00-0339 (cons.), at 8; Order, 99-0288 (Mar. 1, 2000), 21-22; Order, 98-0632 (Mar. 24, 1999), at 5-6.) In addition, Staff cites several dockets from other jurisdictions that use the DCF similarly.

c) Recommendation

Ms. Kight testifies that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. Because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. Along with DCF and CAPM analyses, Ms. Kight considers the observable 6.17% rate of return the market currently required on A-rated utility long-term debt. Based on Ms. Kight's analysis, the investor-required rate of return on common equity for CIWC is 9.86%.

Ms. Kight estimates the investor-required rate of return on common equity by first averaging the DCF-derived estimates of the required rate of return on common equity for the water and utility samples, or 9.75%. She then averages the CAPM-derived estimates of the required rate of return on common equity for the water and utility samples, or 9.97%. Finally, she takes the midpoint of these two estimates. Based on Ms. Kight's analysis, the investor-required rate of return on common equity for CIWC is 9.86%.

The Company's claim that Ms. Kight's cost of common equity provides an insufficient risk premium, Staff contends, is unfounded. Staff argues that its recommended cost of common equity is 9.86% and the concurrent yield on A-rated utility long-term debt was 6.17%, producing a risk premium of 3.69%. Staff states that this rate compares favorably to the 3.41% risk premium implied in the rate authorized recently for Illinois-American Water Company (Order, 02-0690, at 80).

Staff asserts that the difference in return on equity between the instant Docket and the IAWC rate case is attributable to a decline in the required return on the market, and not, as CIWC argues, to a financial strength rating of A rather than BBB. Staff explains that it used the same methodology in 02-0690 as here. Also, the average beta for the water and utility sample groups in IAWC, at 0.55, is very close to the 0.548 average beta in this Docket. Running the CAPM for IAWC with data from August 11, 2003, produces a difference of only 0.02% in the estimated cost of equity. According to Staff, the closeness in CAPM results confirms that the principal reason for the difference in the cost of equity between the two cases is that the required return on the market portfolio fell from 14.8% in 02-0690 to 13.66% in this Docket. Staff notes that Company witness Ahern agrees that the required return on the market declined. Ms. Ahern also admitted that, if she were to update her analysis, her recommended cost would decline. (<u>See</u> Tr. at 193.) Staff notes that eight months separate the tariff filings of IAWC and CIWC, so there is no merit to arguments that the different cost of equity results occurred over the same period since the issuance of the 2000 rate case orders for the respective companies.

Staff points out that CIWC improperly compares Ms. Kight's cost of equity estimate to CIWC's embedded cost of debt, which reflects interest rates that CIWC locked in as early as 1988, rather than the interest rate CIWC would pay on new debt capital. Staff asserts that the error is magnified by comparing Ms. Kight's recommended cost of common equity and CIWC's embedded cost of debt to a risk premium calculated in relation to the risk-free rate. According to Staff, such a comparison is unhelpful, because an equity risk premium measured relative to debt will be smaller than an equity risk premium measured relative to the risk-free rate.

The Company also claims that Ms. Kight's cost of common equity does not permit an adequate opportunity for pretax interest coverage in order to maintain its credit quality and to attract capital on reasonable terms. Staff responds that such claim lacks merit. Ms. Kight's cost of capital recommendation implies a pre-tax interest coverage ratio of 3.2x for CIWC, which is within the 2.8x - 3.4x range established by S&P for a company with a business position of 3 and an A rating. Furthermore, the implied ratio of 3.2x exceeds the mean 2.98x value for A-rated water utilities. Staff therefore concludes that its cost of equity recommendation results in sufficient pre-tax interest coverage.

In response to CIWC's contention that Ms. Kight should have considered the Company's NAIC rating in her cost of equity analysis, Staff offers several reasons why doing so is problematic. First, NAIC does not rate companies such as CIWC; NAIC only rates specific securities issues. Of CIWC's ten long-term debt issues, Ms. Ahern testified that she only has knowledge of three issues with an NAIC rating. (Tr., 184). Second, even if they are a type of credit assessment, NAIC specifies that its ratings are not suitable for use except by NAIC members. Third, Staff contends that CIWC has not provided sufficient evidence of the alleged NAIC ratings upon which it relies.

Staff also asserts that the Company's argument that it is properly designated NAIC-2, equivalent to S&P BBB, is incongruous with Ms. Ahern's own risk premium analysis based on a credit rating of A. (See CIWC Ex. 3.0, 38 and Sch. 13, at 2.) Staff also notes that Ms. Ahern testifies that:

> Ms. Kight's implied credit rating of A+ for CIWC, and therefore likely bond rating, and business position of 3 are consistent with the average S&P bond ratings and assigned business positions of both my proxy groups which are shown as A+ and "2.8" ("3" rounded) for the water group and A and "3.3" ("3" rounded") for the thirteen utilities.…

(CIWC Ex. R-3.0, 12.) According to Staff, Ms. Ahern's own analysis and proxies demonstrates risk commensurate with an A-rating is appropriate, and notes that Ms. Ahern did not adjust her own cost of equity recommendation to reflect the increased risk of the BBB rating. Staff reiterates that Ms. Kight's methodology was approved in Docket 02-0690.

Finally, Staff rejects the Company's contention that Ms. Kight's conclusion is somehow flawed because she did not speak to an analyst at S&P about CIWC. Staff points out that there is no one to speak to about CIWC because it is unrated, and further states that Ms. Kight did discuss with an S&P analyst CIWC's ultimate parent company, Philadelphia Suburban Corp., and its credit-rated subsidiary, Pennsylvania Suburban Water Company.

In summary, Staff recommends adoption of a 9.86% cost of common equity, leading to a weighted cost of capital of 8.87%.

Capital Component	Percent of Total Capital	Cost	Weighted Cost
Short-Term Debt	0.37%	1.78%	0.01%
Long-Term Debt	48.22%	7.90%	3.81%

Preferred Stock	0.35%	5.48%	0.02%
Common Equity	51.06%	9.86%	5.03%
Total	100.00%		8.87%

d) Further Criticisms of the Company's Analysis

(1) Improper Reliance on Historical Data

Staff contends that the use of historical stock and bond data is problematic. First, the use of historical data improperly weights outdated information that investors in the market no longer consider to be relevant. Second, according to Staff, historical data reflects conditions that are unlikely to continue in the future. Encompassing the range of historical data in the analysis improperly implies that upcoming data will revert toward the historical mean, rather than to be based on current trends and conditions. Staff asserts that research has found this premise to be incorrect. Furthermore, Staff argues, there is no method for determining the true value of the mean, even if stock and bond data is mean-reverting. Sample means can be estimated as proxies for actual means, but they are a function of the measurement period used. Furthermore, Staff contends that any chosen measurement period will be arbitrary, causing the results to be uninformative.

Staff asserts that the Commission has rejected the use of historical data in determining an appropriate cost of equity. In Docket 95-0076, the Commission stated:

> Staff's criticism of [the] use of two-month average historical stock prices and historical growth rates in [a] traditional DCF analysis, and historical risk premiums in [a] risk premium analysis are valid. Historical data is inappropriate in determining a forward-looking cost of equity because it contains information that may no longer be relevant to investors.

Order, 95-0076 (Dec. 20, 1995); see also Order, 92-0357 (Jul. 21, 1993) (stating that the company "inappropriately utilized historical data to determine [its] cost of equity").

(2) Illogical Weighting of DCF Growth Rates

In addition to the use of historical data, Staff criticizes Ms. Ahern's method of averaging growth rate types, because, it alleges, certain methods of growth rate estimation appear to be weighted more heavily than others. In particular, Staff charges that Ms. Ahern over-weights the Value Line Projected 2000-2002 to 2006-2008 Growth Rates for earnings per share (EPS) of 8.3% for the Water group and 6.2% for the Utility Group. Those growth rates represent the upper extreme of the range of estimates that she employs: 2.8-8.3% for the Water group and 2.1-6.8% for the Utility Group. Staff is not convinced that Ms. Ahern adequately explains why over-weighting extreme estimates is appropriate.

Furthermore, Staff alleges, missing data causes Ms. Ahern to over-weight the growth rates of certain companies at the expense of others. Value Line does not publish growth rates for four of the seven water utilities comprising the Water group.

Therefore, Staff asserts, the Value Line projected EPS growth rates of the three remaining companies comprise 41% of the average growth rate that Ms. Ahern calculated for the entire sample. In contrast, the Thompson FN/First Call growth rates, which are available for all seven companies in the water sample, constitute less than 29% of Ms. Ahern's average growth rate. In addition, Staff contends, the growth rates for the three companies for which Value Line publishes a growth estimate comprise a 77.7% weight of the water sample growth estimates, even though Ms. Ahern's Water sample comprises seven companies. Staff finds no rational explanation for this unusual weighting scheme, and is not convinced of the soundness of an assumption that the growth rates of the remaining four companies in the Water group are equal to the average Value Line growth rate for the group.

(3) CAPM

According to Staff, CIWC's CAPM Analysis employs two estimates of the market risk premium. The first, an estimate derived from the Ibbotson study, is based entirely on historical data. Staff contends that the problems with using historical data, which it discusses separately, afflict the Ibbotson study.

Staff asserts that the second estimate by CIWC, calculated from Value Line median market dividend yields and price appreciation, contains two errors. First, while the median identifies the middle value of the data set, it provides no information about the magnitude of the difference between the middle value and other data points. Ultimately, as applied here, the median fails to properly weight the relative market values of the securities composing the market portfolio. The common stocks of larger companies more greatly affect the market return because they constitute a greater proportion of the market than those of smaller companies. Nevertheless, Staff argues, the median growth estimate does not apply higher weights to larger companies, resulting in the over-weighting of the contributions of smaller companies.

Ms. Ahern compounds this problem, Staff claims, by improperly determining the median dividend yield and growth rates from two different samples. Common stocks that do not pay dividends were excluded from the sample from which the median dividend yield was derived. Conversely, the median appreciation projection reflects all 1701 stocks in the Value Line research group, dividend paying or not. The dividend yield of non-dividend paying stocks is 0%. Staff criticizes Ms. Ahern's assumption that the median would remain the same after adding non-dividend paying stocks back into the model. According to Staff, of the 1,701 companies Value Line currently reviews, 737 paid dividends last quarter, while 964 did not. Since the number of non-dividend companies exceeds the number of dividend companies, the median dividend yield for all of Value Line's 1,701 companies equals zero. Staff therefore concludes that adding the dividend yield solely of those stocks that pay dividends to the estimated price appreciation of <u>all</u> stocks results in an over-estimation of the overall return on the market.

(4) Empirical CAPM

In response to the Company's use of this particular model, Staff states that the Commission already rejected the use of the Empirical CAPM ("ECAPM") in Docket 01-

0444. (Order, 01-0444, March 27, 2002, pp. 16-17.) Staff also contends that the adjustments to the CAPM that result in the ECAPM are based on empirical testing rather than financial theory, so the ECAPM should be applied in a manner that is consistent with the conditions under which it was developed. Specifically, the measure of risk used within the ECAPM should be consistent with that used in the empirical studies from which the model was developed. According to Staff, Ms. Ahern's application of the ECAPM fail in that regard.

The basis of CIWC's ECAPM is Regulatory Finance: Utilities' Cost of Capital, by Roger A. Morin. That text cites a study by Litzenberger et al., which adopts raw beta as the measure of risk in its tests of the relationship between risk and realized returns. In contrast, Staff asserts, Ms. Ahern applies Value Line adjusted betas to her ECAPM rather than the raw betas used in Litzenberger et. al. Importantly, Staff contends, Litzenberger et. al. indicate that globally adjusted betas, such as those which Value Line publishes, solve the discrepancy between the theoretically predicted and empirically observed relationship between risk and return. By using adjusted betas, Staff cautions, Ms. Ahern already has effectively transformed her CAPM into an ECAPM. Including an additional beta adjustment in the ECAPM model results in an inflated estimate of the cost of common equity.

(5) Risk Premium Analysis

Staff notes that the Commission recently rejected the use of this particular Risk Premium Model in Docket 02-0837. (Order, 02-0837, at 34, 38). Staff also contends that CIWC's RPM contains several flaws. First, a market risk premium-based beta is improperly applied to a non-market risk premium. Second, two different long-term corporate bond yields are inappropriately substituted for the risk-free rate within the same risk premium model. Third, according to Staff, the common equity risk premium is estimated inaccurately.

With respect to the first problem, Staff states that the application of a market risk premium-based beta to a non-market risk premium is improper because beta measures a particular type of risk. It cannot be assumed to accurately measure any other type of risk. While the Company's RPM is derived from the CAPM, it improperly substitutes a corporate bond yield for the risk-free rate. Staff explains that this leads to systematic underestimation of the cost of equity for companies with a beta greater than one, and systematic overestimation of the cost of equity for companies with a beta less than one. Staff notes that both the water and utility samples have betas below one, implying that the cost of common equity is overestimated by this calculation.

Staff also charges that the Company's RPM uses two different long-term corporate bond yields, resulting in different rates of return for samples that have the same level of risk. Staff points out, however, that a basic assumption of financial theory states that investors require identical returns from two securities with identical risk. According to Staff, for companies and proxy groups with a beta less than one, CIWC's RPM overestimates the cost of equity.

Finally, the adjusted equity risk premium used by CIWC is inappropriate for its use of historical data. In addition, it is based upon S&P's Public Utility Index. Staff contends that the Company failed to demonstrate that this Index is comparable in risk to CIWC.

(6) Comparable Earnings Model

Staff notes that the Commission has repeatedly rejected use of the comparable earnings methodology. (See Order, 89-0033, November 4, 1991, p. 15; Order, 92-0448/93-0239 Consol., October 11, 1994, p. 173; Order, 99-0121, August 25, 1999, p. 68; and Order, 03-0008/03-0009 Consol., October 17, 2003, pp. 88-89). The Company does not provide the Commission with any valid reason for reversing this policy, Staff argues.

Staff also alleges that the Company's CEM is distorted by its use of historical data, inconsistencies in the data set, and by potential differences in accounting practices across industries. Also, the CEM erroneously assumes that a combination of realized and expected returns on book value (i.e., "accounting earnings") is an appropriate estimate for the investor-required rate of return. Staff explains that the cost of common equity is the market-required rate of return demanded by investors. In contrast, the CEM relies on the accounting return on book value of common equity, which may be more or less than the rate of return investors require.

Staff disagrees with CIWC that its CEM model is market-based simply because market-based measures of risk were used to select the CEM samples. If the required return from the CEM model is market based, Staff argues, measures of risk should be positively related with the measures of return. According to its own statistical analysis, however, the relationships between Ms. Ahern's measures of risk and her measures of return are either negative or insignificantly different from zero. Staff therefore concludes that merely forming samples from market measures of risk is insufficient to convert accounting rates of return into market-based rates of return.

(7) Size Based Premium

Staff asserts that the Company's size-based risk premium has no theoretical basis, and relies on an empirical study that is not applicable to CIWC. The Ibbotson Associates study, which forms the basis of CIWC's size-based risk premium adjustment, is based on the stocks listed on the New York Stock Exchange ("NYSE"), American Stock Exchange ("AMEX"), and National Association of Security Dealers Automated Quotation System ("NASDAQ"). Neither the Ibbotson Associates study, nor the Brigham text also cited, refer to utility stocks. Staff also argues that the Brigham text defines a small firm as one with a market capitalization of less than $20 million, compared to CIWC's $110 million in book capitalization. Staff contends that the entire basis to apply a size-based risk premium to CIWC is unfounded.

Staff also argues that a size-based risk premium was presented in an earlier CIWC rate case, 97-0351, and was rejected because the company failed to demonstrate that there is a direct relationship between the size of a utility and its risk. Staff contends that Ms. Ahern has not remedied that defect.

3. Commission Conclusion

The Commission observes that both the Company and Staff presented extensive testimony and analysis regarding the cost of common equity. The position of both parties are stated in their testimonies and briefs, which are summarized above.

First, the Commission rejects the use of the comparable earnings analysis. The Commission has repeatedly found that the comparable earnings approach is an unsound basis for estimating a utility's cost of common equity. In the Commission's view, there is no economic basis for concluding that the comparable earnings approach provides a valid estimate of the Company's forward looking, investor required rate of return. The Commission is not convinced that looking to the return on book equity of non-price regulated firms provides meaningful information when estimating the Company's cost of common equity. Similarly, the language cited by CIWC from the <u>Hope</u> case supports the ratemaking principles applied by this Commission. It is too general, however, to lend particular support to the CEM.

The Commission also rejects the empirical CAPM model as implemented by the Company. According to Staff, the use of adjusted betas with the ECAPM results in an inflated estimate of the cost of equity. The Commission concurs that the Company's use of adjusted betas in the ECAPM is improper and leads to unreliable results. Consistent with its long-standing practice, the Commission finds the use of adjusted betas in the traditional CAPM to be a reasonable basis for estimating a utility's cost of common equity.

Although the Company offered several criticisms of Staff's CAPM analysis, the Commission finds that it is reasonable. The Company failed to demonstrate a significant problem with either the betas or the market returns calculated by Staff. The Company's arguments that Staff's calculations are unnecessary and do not model investor behavior are unavailing. Estimating the Company's cost of common equity necessarily involves using proxies for unobservable information.

With respect to the DCF analyses, the Commission rejects the Company's contention that the proper measure of financial strength is BBB. The Commission can not rely on the NAIC-2 rating, both because the rating applies to certain specific securities issues rather than CIWC as a whole, and because the NAIC itself cautions that such ratings should not be used except by its own members. The Commission also finds the BBB claim doubtful, in light of the fact that the Company's own witness determined that the proper ratings for her water and utility samples correspond to A+ and A respectively.

The Commission is aware that historical data has a place in many cost of capital analyses. The instant objective, however, is to estimate the forward-looking cost of common equity. For this reason, the Commission has consistently rejected the use of average common stock prices, and has accepted the use of spot common stock prices when implementing the DCF model. The Commission continues to believe that the use of spot common stock prices in the DCF model is superior to the use of average prices.

In addition, the Commission has concerns regarding the growth rates used by the Company in implementing the DCF model. While the application of informed judgment is necessary in estimating the cost of common equity, the Commission requires a full explanation of why and how such judgment is used. Setting aside the questionable use of historical information used in developing its growth rates, the Company has failed to adequately explain how and why it combined various data to develop the growth rates it used in implementing the DCF model.

The Commission also rejects the Company's suggestion that the DCF model produces a downward-biased cost of common equity due to a variation between the book and market values of common equity. The argument for a market-to-book ratio adjustment has been made, and rejected by this Commission, numerous times in previous cases. The Company's arguments here are not significantly different, and the Commission continues to find such arguments to be without merit.

Furthermore, the Commission is of the opinion that a size-based risk premium is not warranted for CIWC. Even if a size effect exists generally, there is insufficient evidence to conclude that it applies to CIWC. Because the evidence does not support a conclusion that CIWC has an inherently higher level of risk due to its size, a size-based risk premium should not be included in the cost of equity.

After considering all of the arguments, the Commission finds that several models supporting the Company's recommended cost rate should not be accepted, and others include elements that raise concern. On the other hand, Staff's methodology does not raise such questions, and does not rely on models that have been previously rejected. The Commission does not find the Company's criticisms of Staff's analysis to be persuasive. Accordingly, the Commission concludes that the required rate of return on common equity for CIWC's water operations is 9.86%.

C. Approved Rate of Return on Rate Base

The Commission concurs that the capital structure proposed by the Company and Staff is appropriate and should be adopted. The Commission also adopts Staff's recommendation for a 9.86% cost of common equity. Applying this to the capital structure agreed upon by Staff and the Company results in an 8.87% weighted cost of capital, as shown below.

CIWC's Overall Cost of Capital

Capital Component	Ratio	Cost	Weighted Cost
Short-Term Debt	0.37%	1.78%	0.01%
Long-Term Debt	48.22%	7.90%	3.81%
Preferred Stock	0.35%	5.48%	0.02%
Common Equity	51.06%	9.86%	5.03%
Total	100.00%		8.87%

V. RATE DESIGN

A. Company Position

The Company urges that the same percentage increase be applied to each class of customer. The overall increase to annual revenue is 24.14% and the increase to each customer class is 24.14% under CIWC's proposal. The Company notes that, regardless of the rate design adopted in this proceeding, it currently has no eligible customers for its Standby Rate and Large Industrial Rate. The Company agrees to notify the Commission's Manager of Rates in the event that either rate becomes applicable to a customer.

The Company contends that, based on a disproportionately high percentage increase for larger volume users compared to residential customers, the results of the cost of service study ("COSS") performed by Staff witness Luth are not just and reasonable. The Company asserts that such a significantly disproportionate increase will negatively affect the industrial base in Kankakee, where the economy is already fragile. CIWC understands local industrial customers to share this view. The Company also states that Mr. Luth's alternative proposal would move industrial customers toward the full cost of service by class, but moderate the rate shock of his initial proposal. According to CIWC, rate increases under the two proposals would be:

Customer class	Staff original proposal	Staff alternate proposal
Residential	21.7%	24.0%
Commercial	27.0%	24.1%
Industrial	35.1%	28.1%
Public Authorities	32.9%	26.5%

The Company also argues that the impact on customers must not be addressed by dollar increases in the customer charge or the commodity or volumetric charges, but rather by reviewing the percentage increase to each class. On this basis, the Company concludes that the Commission should adopt CIWC's proposed flat rate increase. In lieu thereof, Mr. Luth's alternative rate design will cause the least economic harm.

B. Staff Position

The Company proposed an across-the-board percentage increase in water rates, in which the customer charge and each of the three usage block rates would be increased by the percentage of the increase in base tariff revenues. Staff proposed rates based upon the results of a cost of service study ("COSS") for the test year ending December 31, 2004. Accordingly, Staff's proposed rates vary among billing categories, rather than the same percentage increase for all rates.

As an alternative, Staff suggested an increase based in part upon the COSS, with usage rates capped at the amounts that the Company proposes. The remaining revenue requirement would be recovered by setting the customer charges for larger meters at above-COSS levels.

Staff also recommends that the Company notify the Commission's Manager of Rates if its currently unused, but still available, Standby rate or Large Industrial rate becomes applicable to any customer. Staff states that the implications for the Company's revenues and income from the Large Industrial rate are significant. Notification should include a projection of annual revenues if the newly applicable Large Industrial or Standby rate represents 5 percent or more of the projected operating revenues or incremental income from the Company's Kankakee Water Division.

1. Staff's COSS proposal

Staff explains that a current test year COSS is important to meeting the goal of assigning the costs of supplying public utility services to those who cause the cost to be incurred. Staff's COSS assists the Commission in meeting this goal because the COSS distributes costs to the various customer classes in accordance with their requirements for service, with rates designed to recover from each customer class the cost to serve that class. The COSS also determines the amount in each cost component: base costs, extra capacity costs, customer costs, and direct fire protection costs. Because the COSS accumulates the amount of each cost component for each customer class, customers can be billed appropriately according to usage and meter size.

According to Staff, the Company objects to the COSS rates primarily because the percentage increase to large industrial users under Staff's recommendation is more than that for residential and commercial users. Staff also views the Company to argue that its COSS is flawed because it yielded different results than the previous study in Docket 00-0337. Staff explains that the COSS results show changes in the Company's cost structure and customer group usage patterns, which results in small shifts in cost responsibilities from one customer group to another. These shifts, Staff argues, highlight the reason why rates should be based on a current COSS.

In comparing this COSS proposal to rates set in Docket 00-0337, Staff explains that industrial customers would be responsible for a smaller portion of the cost of service, and would pay a smaller portion of the total revenue. In particular, their coverage of the cost of service slips from 14.22% to 13.84%, while the share of revenues collected from them drops from 14.1% to 13.53%. Staff states that these results are consistent with a decline in usage by industrial customers, from 32.69% in the 2000 rate case to 30.89% in this case.

Furthermore, Staff argues, CIWC's assessment of the magnitude of the increase to large water users is incomplete. Staff proposes an increase of slightly more than 43 cents, from $1.7500 to $2.1816, per hundred cubic feet ("CCF") of usage billed in the first usage block. The first block primarily represents consumption by small users. For the third and bottom-priced usage block, which covers nearly 89 percent industrial usage billing, Staff proposes an increase of slightly more than 30 cents, from $0.8230 to $1.1280, per CCF. On a per-CCF basis, Staff argues, the increase in the third block usage rate under its proposed rates would be about 71 percent of the first block increase. The reason that a 30 cent increase to third block rates under the COSS proposal corresponds to a 37.1% increase, while a 43 cent increase to first block corresponds to a 24.7% increase, is because the third block rate is lower. Staff points out that the magnitude of the third block increase also is much less than the first block increase.

On an overall basis, Staff's proposed rates still require residential customers to pay more than the average amount per CCF, and require industrial customers to pay less than the average amount per CCF. Total metered revenue per CCF under Staff's proposed rates, which includes the customer charge and usage charge revenues, is $2.5939 per CCF, assuming Staff's revenue requirement. Residential total metered revenue is $3.7567 per CCF, while industrial total metered revenue is $1.2495 per CCF. Residential customers, therefore, shoulder the system cost of service at a rate that is both above average across all customer classes, and is approximately three times the average rate that industrial customers pay. Furthermore, under Staff's proposal, residential customers will assume 52% of the rate increase, while industrial customers will only bear 17%. According to Staff, these figures refute popular arguments presented by the Company, to the effect that industrial consumers pay higher rates than any other group.

Staff concludes that the Commission should set rates based on the COSS. Reducing the percentage increase to large water users will increase the already-larger unit cost to smaller users. After accounting for revenue formerly collected under the Qualifying Infrastructure Plant ("QIP") charge, Staff estimates that the rate hike requested by the Company amounts to an increase of 29.5% in customer charges and usage rates. Staff attributes any rate shock thereto, rather than to the assignment of costs by the COSS.

2. Staff's alternate proposal

Staff offers an alternate proposal that is also derived from the COSS, but smoothes the percentage increase for large water users. Under this plan, residential customers would be required to pay approximately 101.9 percent of their cost of service. Commercial, industrial, and public authority customers would pay less than their cost of service, ranging from 94.7 percent of cost of service for industrial customers to 97.7 percent for commercial customers. Each usage block rate would be capped at the Company-proposed level.

Customer charges for meters 4 inches in diameter or more would be increased to above the cost of service in order to allow the Company to recover its test year revenue requirement. Limiting the customer charge increase above cost of service to meters 4 inches in diameter or more would exclude residential customers from customer charges that are above cost of service.

This alternative would move industrial customers toward their cost of service rates, but would limit the percentage of the increase to less than the amount that the Company announced in filing its proposed rates. Large water users, therefore, would not be surprised by the amount of increase in the cost of water after the conclusion of this Docket.

C. Approved Rate Design

Consideration of a current COSS is important to setting just and reasonable rates. The Commission accepts that a current COSS properly allocates costs to the customer classes for whom they are incurred, and accounts for shifts in service patterns that may occur over time. Accordingly, the Commission concludes that it is inappropriate to adopt a flat percentage increase to all rate categories. The effect of such a rate design is to ratify a COSS that may no longer reflect market conditions accurately, at the expense of one that is current. The Commission concludes that it is not reasonable to ignore current information provided by the new COSS, and therefore declines to adopt the Company's proposed rate design.

This leaves a choice of the two Staff proposals. Staff's original rate design is based purely on the COSS conducted for this Docket, while its alternative proposal reflects an adjusted COSS-based rate design. The Commission notes that the parties discussed at length the impact of the rates on the customer classes. Both the Company and Staff convey in their arguments that Staff's alternative proposal mitigates the impact of the rate increase to large water users. As Staff explains, this is achieved by assigning a higher-than-COSS usage rate to the first volumetric block to allow more favorable rates to the higher volume blocks. The balance of the required revenue is assessed in the customer charge for larger, non-residential meters. The volumetric rates in this proposal are capped at levels equal to those in the Company's original proposal.

The Commission is willing to accept a rate design that mitigates potential rate shock to larger volume users, if it can be accomplished without compromising the reasonableness of the rates to which smaller customers will be exposed. In this case, residential customers comprise the small-volume users. The expected impact of Staff's two proposals on this customer group is quantified in Staff exhibits 10.2 and 10.4. According to these exhibits, the typical monthly bill for a residential customer of CIWC is $26.91 under the rates set in the previous case. This figure would rise to $32.27 under Staff's COSS proposal, $32.96 under Staff's alternative proposal, and, for comparison, $34.86 under the Company proposal already discarded. The monthly difference between Staff's original and alternative proposals appears to be less than $1.00 for residential customers with relatively typical usage.

In light of the apparently substantial benefit that will accrue to larger-volume customers and the relatively minimal impact on small-volume customers, the Commission concludes that it is appropriate to adopt the adjusted COSS rate design rather than the pure COSS rate design. Accordingly, Staff's alternate proposal is accepted.

VI. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having given due consideration to the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) Consumers Illinois Water Company provides water service to the public within the State of Illinois, and, as such, is a public utility as defined in Section 3-105 of the Public Utilities Act;

(2) the Commission has jurisdiction over the Company and the subject matter herein;

(3) the recitals of fact and conclusions of law reached in the prefatory portion of this Order are supported by the evidence of record, and are hereby adopted as findings of fact and conclusions of law; Appendix A attached hereto provides supporting calculations;

(4) the test year for the determination of the rates herein found to be just and reasonable should be the 12 months ending December 31, 2004; such test year is appropriate for purposes of this proceeding;

(5) for the test year ending December 31, 2004, and for the purposes of this proceeding, the Company's rate base is $ 40,622,884;

(6) a just and reasonable return which CIWC should be allowed to earn on its net original cost gas rate base is 8.87%; this rate of return incorporates a return on common equity of 9.86%;

(7) the rate of return set forth in Finding (6) results in base rate operating revenues of $13,077,122 and net annual operating income of $3,603,250 based on the test year approved herein;

(8) CIWC's rates which are presently in effect are insufficient to generate the operating income necessary to permit CIWC the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(9) the specific rates proposed by CIWC in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; CIWC's proposed rates should be permanently canceled and annulled consistent with the findings herein;

(10) CIWC should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of $13,077,122, which represent an increase of $2,579,278 or 24.57%; such revenues will provide CIWC with an opportunity to earn the rate of return set forth in Finding (6) above; based on the record in this proceeding, this return is fair and reasonable;

(11) the determinations regarding cost of service and rate design are contained in the prefatory portion of this Order, are reasonable for purposes of this proceeding; the tariffs filed by CIWC should incorporate the rates and rate design set forth and referred to herein;

(12) new tariff sheets authorized to be filed by this Order should reflect an effective date not less than 5 working days after the date of filing, with the tariff sheets to be corrected, if necessary, within that time period;

(13) if either the Standby Rate or the Large Industrial Rate becomes applicable to any customer, CIWC should notify the Commission's Manager of Rates within 30 days; and

(14) all motions, petitions, objections, and other matters in this proceeding which remain unresolved should be disposed of consistent with the conclusions herein.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the tariff sheets presently in effect rendered by Consumers Illinois Water Company for the Kankakee Water Division are hereby permanently canceled and annulled effective at such time as the new tariff sheets approved herein become effective by virtue of this Order.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general rate increase, filed by Consumers Illinois Water Company on May 21, 2003, are permanently canceled and annulled.

IT IS FURTHER ORDERED that Consumers Illinois Water Company is authorized to file new tariff sheets with supporting workpapers in accordance with Findings (10), (11), and (12) of this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that all motions, petitions, objections, and other matters in this proceeding which remain unresolved are disposed of consistent with the conclusions herein.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

DATED:	March 1, 2004
BRIEFS ON EXCEPTIONS DUE:	March 11, 2004
REPLIES TO EXCEPTIONS DUE:	March 17, 2004

Ian Brodsky,
Administrative Law Judge